

Possible Impact of a Rise in US Interest Rates on the Hong Kong Stock Market

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Summary

- *The current Federal Funds Target Rate (FFTR) in the US of 1.75% is far below the trend level, and it will continue to remain “low” even if there are more interest rate hikes. In addition, the current Best Lending Rate (BLR) in Hong Kong is 3.375 percentage points higher than the FFTR, and is still higher than the usual gap of 3 percentage points. Thus, even if there is a rise in the US interest rate, it may not necessarily lead to an immediate hike in the BLR by the same magnitude. Similarly, the current level of the Aggregate Balance is higher than the “normal” level. Even if there is a rise in the US interest rate and there is an outflow of capital, it may not necessarily lead to an immediate hike in the BLR by the same magnitude. Therefore, the impact of an interest rate hike in the US on the Hong Kong stock market is expected to be rather limited.*
- *The US economy is at the start of a recovery and the inflation rate is far from high. It is perceived that the recent hikes were precautionary in nature.*
- *A review over the last four interest rate cycles shows that the relationship between interest rate movements and the performance of the HSI is inconclusive. Among other factors, the performance of the HSI is affected by the performance of major overseas markets, local market sentiment and developments in the Mainland economy.*

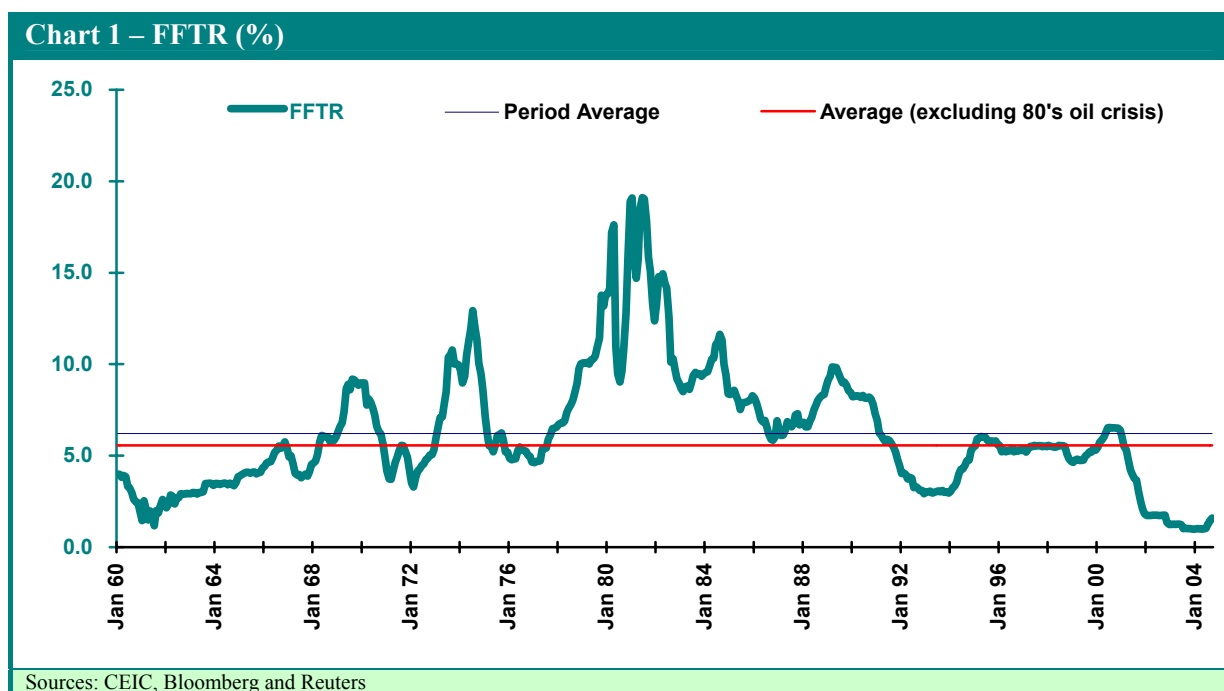
¹ This paper is for pure fact-finding and research purpose, and is not an attempt to comment on the developments of any markets/companies or interpret the policies concerned. The views expressed in this paper do not represent those of the SFC.

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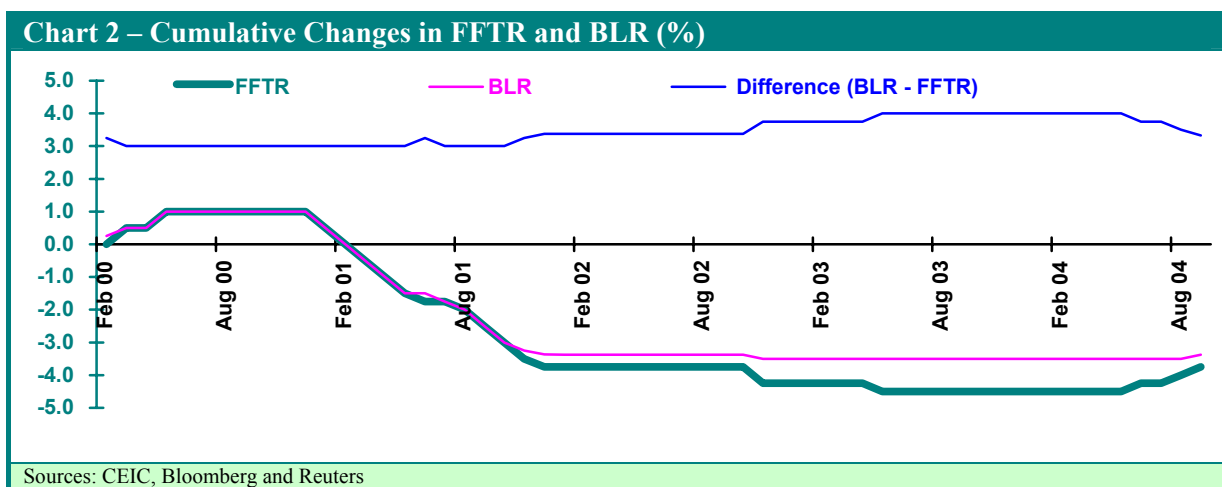
- An increase in the interest rate raises the cost of funds. This will have an impact on businesses as well as investors. Because it is more attractive to put the money in banks, businesses will slow down the implementation of their business plans and investors will reduce/stop their investments in the financial markets. Nevertheless, the precise impact will depend on, among other factors,
 - the absolute level of the interest rate – if the interest rate is at a very low level, the impact of an increase in the interest rate is less apparent; and
 - the perception about the interest rate hikes – if the hikes are perceived to be precautionary in nature (that the Federal Reserve System is trying to avoid inflation in advance), the impact of an increase in the interest rate is less apparent.

Absolute level of the interest rate

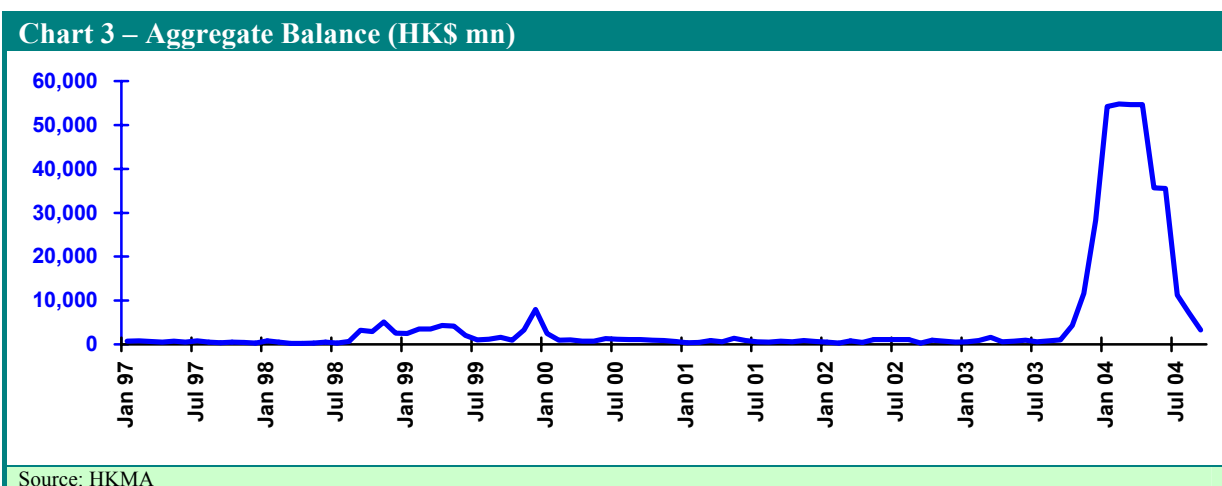
- Prior to the three interest rate hikes which took place in June, August and September, the benchmark interest rate, the FFTR, was at a 45-year record low of 1% (Chart 1). After the three hikes, the FFTR was 1.75%, still far lower than the period average of 6.2%. Even if the period of early 1980s (i.e. the oil crisis period) is excluded, the average was 5.6%. Alternatively, the average was 5.3% if we concentrate on the recent 20 years, and it was 4.3% if we concentrate on the recent 10 years. In other words, the current FFTR level is “abnormally” low and will continue to remain “low” for some time even if there are more hikes. Therefore, the impact of an interest rate hike is expected to be rather limited.



- Under the linked exchange rate system, the interest rate movements in Hong Kong follow those in the US. For instance, the BLR in Hong Kong has been 3 percentage points higher than the FFTR since early 2000 (Chart 2). However, during the latest interest rate cycle (i.e. during January 2001 – June 2003), the FFTR was cut 13 times for a total of 550 basis points (bps), but the BLR in Hong Kong was only cut 12 times for a total of 450 bps. Therefore, the gap between the BLR and the FFTR widened to 4 percentage points during May 2003 – June 2004. This has created a buffer for Hong Kong to keep the BLR unchanged, despite increases in the FFTR. At present, the BLR is 3.375 percentage points higher than the FFTR, and this is still higher than the normal level of 3 percentage points. Thus, even if there is a rise in the US interest rate, it may not necessarily lead to an immediate hike in the BLR by the same magnitude.



- In addition, the Aggregate Balance of about HK\$3.2 bn as of the end of September 2004 was higher than the normal level of about HK\$300-600 mn during 1997 – 2003 (Chart 3). Bankers and market analysts conjecture that the BLR will rise when the Aggregate Balance falls to the “normal” level. In other words, even if there is a rise in the US interest rate and there is an outflow of capital, it may not necessarily lead to an immediate hike in the BLR by the same magnitude.



Perception about the interest rate hikes

5. Major economic figures indicate that the US economy is at the start of a recovery and the inflation rate is far from high. Over the past 6 months (Table 1),
- the increases in non-farm payroll were in general declining and below market expectations;
 - retail sales declined in three months;
 - industrial production dropped in two months; and
 - increases in core consumer prices remained contained.

	Increase in Non-farm Payroll ('000 persons)	Retail Sales (%)	Industrial Production (%)	Core Consumer Prices (%)
Apr 2004	324	-0.8	0.5	0.3
May 2004	208	1.4	0.8	0.2
Jun 2004	96	-0.7	-0.3	0.1
Jul 2004	85	1.0	0.7	0.1
Aug 2004	128	-0.2	-0.1	0.1
Sep 2004	96	1.5	0.1	0.3

Sources: CEIC, Bloomberg and Reuters

6. Therefore, economic analysts considered that the recent interest rate hikes were only precautionary measures, especially in the midst of rising oil prices during the last few months.

Past Experience of US Interest Rate Cycles and Their Impacts on the Hong Kong Stock Market

7. To assess the impact of interest rate changes on the performance of the HSI, the last four interest rate cycles in the US are analysed.
- June 1989 – September 1992 (when the FFTR was cut 22 times for a total of 675 basis points);
 - February 1994 – February 1995 (when the FFTR was raised 7 times for a total of 300 basis points);
 - June 1999 – May 2000 (when the FFTR was raised 6 times for a total of 175 basis points); and
 - January 2001 – June 2003 (when the FFTR was cut 13 times for a total of 550 basis points).
- The FFTR changed in 1997 and in 1998, but such changes were related to events such as the Asian Financial Crisis and were not considered to be a complete interest rate cycle.
8. A review of the last four interest rate cycles shows that the relationship between interest rate movements and the performance of the HSI is inconclusive. Of the four interest rate cycles, two cycles were interest rate increases and the other two were interest rate decreases (Table 2).

- For the two rising interest rate cycles, the HSI rose once and declined once.
- For the two declining interest rate cycles, the HSI also rose once and declined once.

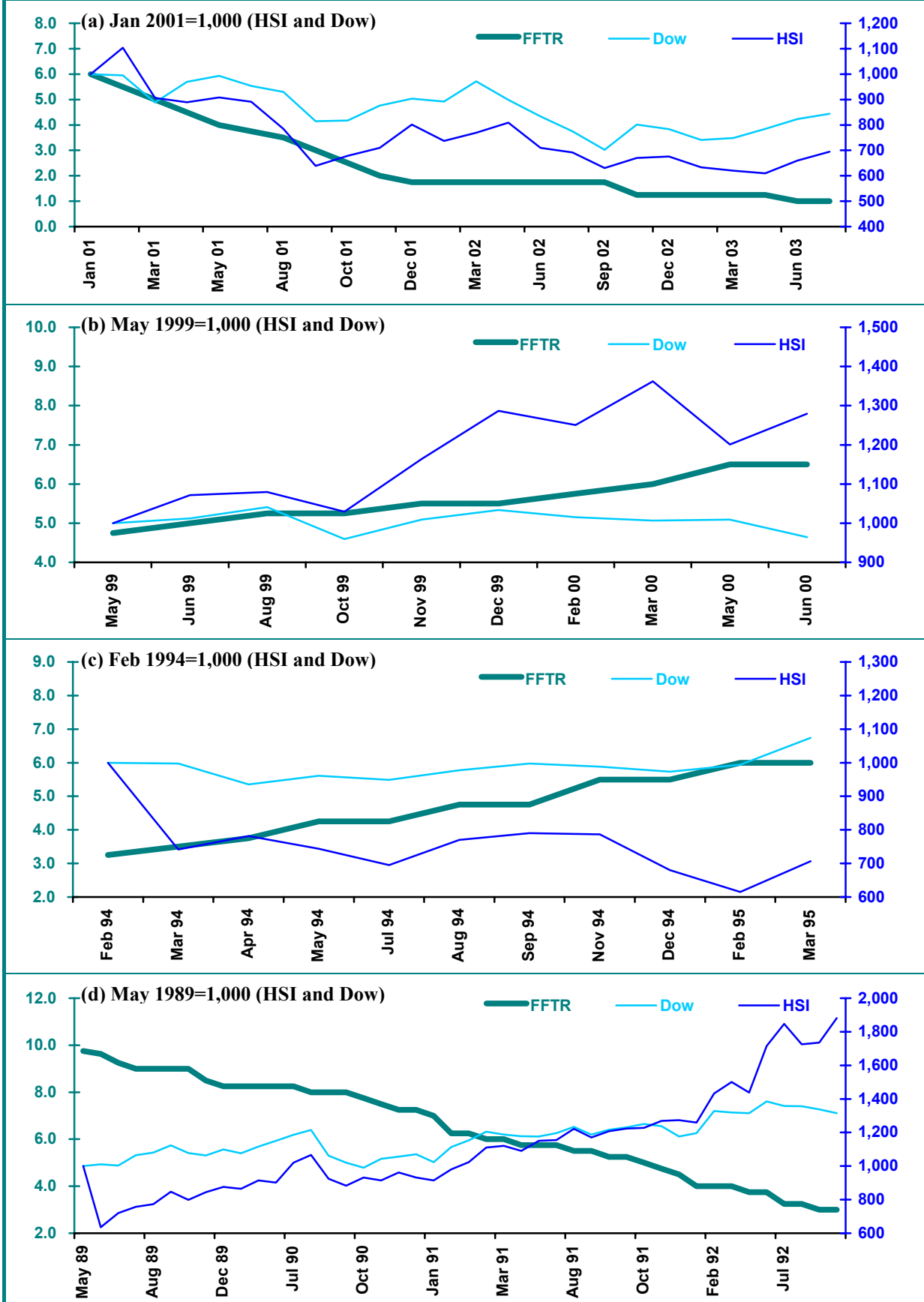
It should be noted that the impacts of other factors on the performance of the HSI cannot be isolated completely.

Interest Rate Cycle	Change in FFTR	Change in HSI	Change in Dow
6/1989 – 9/1992	-675 bps	+109.1%	+27.2%
2/1994 – 2/1995	+300 bps	-30.9%	+0.6%
6/1999 – 5/2000	+175 bps	+19.4%	-3.4%
1/2001 – 6/2003	-550 bps	-33.2%	-12.8%

Remark: Changes in the HSI and the Dow are calculated from the first FFTR change to one month after the last FFTR change.
Sources: Federal Reserve System, HKEx, Bloomberg and Reuters

- The relationship between the HSI and the Dow is also inconclusive. During the four interest rate cycles, the Dow advanced in two cycles, but dropped in the other two. The general directions where the HSI moved were not necessarily the same as those for the Dow during the cycles. Again, the impacts of other factors on the HSI cannot be isolated.
- In addition to interest rate movements and the performance of major overseas markets, the performance of the HSI was very much affected by other factors such as local market sentiment and developments in the Mainland economy.
 - During January 2001 – June 2003, despite the cuts in the FFTR by a total of 550 basis points, the HSI declined 33.2% (Chart 4a). Among other factors, this was due to the bursting of the tech bubble. The HSI dropped 34.1% during the first nine months of 2001, whilst it remained relatively stable over the remaining period.
 - During June 1999 – May 2000, despite the increases in the FFTR by a total of 175 basis points, the HSI gained 19.4% (Chart 4b). Among other factors, this was due to the tech bubble. For instance, the HSI advanced 31.3% during the five months to March 2000.
 - During February 1994 – February 1995, apart from the impact of the hikes in the FFTR, the decline in the HSI of 30.9% was attributable to the macro-economic measures adopted in the Mainland (Chart 4c). Over the same period, the red chip and H-share indices plunged 53.1% and 37.9% respectively.
 - During June 1989 – September 1992, apart from the impact of the cuts in the FFTR, the surge in the HSI of 109.1% was due to the rebound from the June 4 Incident in 1989 and Deng Xiaoping's visit to Shenzhen in early 1992 (Chart 4d).

Chart 4 – HSI, Dow and FFTR



Remark: Charts are drawn from one month before the first FFTR change to one month after the last FFTR change.

Sources: Federal Reserve System and Bloomberg