

Interest Rate Differentials Under an Exchange Rate Convertibility Zone: A Carry Trade Perspective

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Summary

This study is motivated by the negative HKD-USD interest rate differentials observed after the US interest rate hike on December 17, 2015. We first analyse two practical concerns that are typical from the perspective of a carry trader: (1) the difference in borrowing rate and lending rate of a currency, and (2) the exchange rate loss perceived from prevailing HKD/USD market condition using a truncated distribution that reflects full confidence in the HKD/USD Convertibility Zone under the Linked Exchange Rate System (LERS). We find that these considerations largely rationalize the observed interest rate differentials. We then perform robust Bayesian statistical inference on the negatively skewed effective carry-to-risk ratios. We find that the most probable and the typical effective carry-to-risk ratios are economically small. Our results are consistent with the Hong Kong Currency Board's intrinsic stabilizing mechanism functioning efficiently.