

Hong Kong's Money

The History, Logic and Operation of the Currency Peg

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Hong Kong University Press is honoured that Xu Bing, whose art explores the complex themes of language across cultures, has written the Press's name in his Square Word Calligraphy. This signals our commitment to cross-cultural thinking and the distinctive nature of our English-language books published in China.

"At first glance, Square Word Calligraphy appears to be nothing more unusual than Chinese characters, but in fact it is a new way of rendering English words in the format of a square so they resemble Chinese characters. Chinese viewers expect to be able to read Square Word Calligraphy but cannot. Western viewers, however are surprised to find they can read it. Delight erupts when meaning is unexpectedly revealed."

— Britta Erickson, *The Art of Xu Bing*

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Introduction

Figure 1.1 below suggests that something rather dramatic happened to Hong Kong's exchange rate system in 1983. In fact, that was the year in which Hong Kong re-introduced, after a gap of some eleven years, a currency board arrangement.

HKD per USD

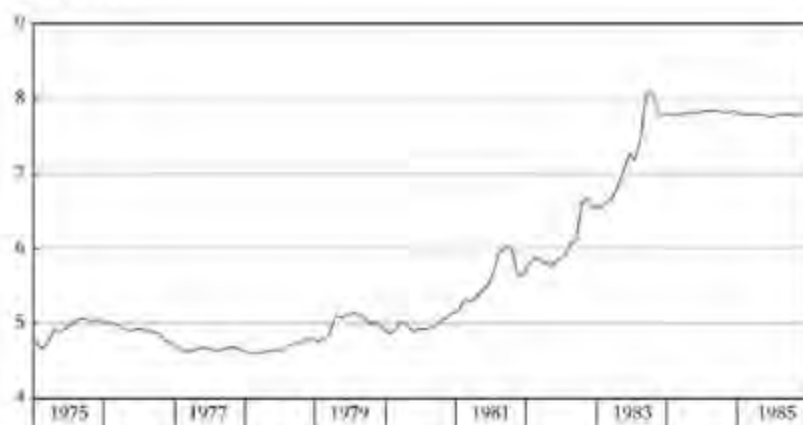


Figure 1.1 Exchange Rate

Currency boards are not very widely practised today. Although there is scope for debate about the relative merits of the currency board, compared to the more usual approaches to monetary policy, standard textbooks in macroeconomics, as well as more specialised ones in monetary economics,

tend to focus on the monetary systems of the world's major economies, and to give less than adequate space to alternatives such as the currency board.

As to Hong Kong, there have, over the years, been a number of authoritative papers and speeches from the Monetary Authority and academic sources, describing and analysing different aspects of Hong Kong's system and its history, but there has been no single volume which draws all the threads together.

This book aims to fill that gap. It seeks to explain how Hong Kong's present monetary system, which is centred on a fixed exchange rate against the US dollar under a currency board regime, evolved historically; how it is distinct from monetary systems in most other economies, how it operates; and how well it has performed. The institutional environment — the Monetary Authority and its interaction with the Financial Secretary, and the role of the Exchange Fund — is also examined. The most detailed focus is on the period since 1983, but there is also extensive discussion of earlier history.

The book is intended both to satisfy the curiosity of the layman or the historian, and to provide substance for students or teachers of monetary economics. Although the text can be read as a continuous narrative, some people may prefer to use it as a reference source. It does not purport to be an exhaustive monetary textbook, and should therefore be regarded more as a companion to than a substitute for the established textbooks. For the benefit of the wider readership, there is no algebra, while a glossary provides explanations of various terms that may not be familiar to all.

Chapter 2 presents a summary snapshot of the key features of Hong Kong's currency board as it stands today, for the benefit of those who simply want to know the bare bones of what it is and how it operates. Chapter 3 is aimed mainly at those with an interest in the technical analysis of monetary economics. It presents the analytical framework for the operation of monetary policy and explains the key features according to the 'mainstream' model that is followed in most economies. It lays the groundwork for analysis of how a currency board differs, which is then covered in Chapter 4. Chapter 5 traces currency developments in China in the run-up to its abandonment of the silver standard in 1935. Those developments had an important bearing on Hong Kong's decision to initiate a currency board in the same year — a process which is explored in Chapter 6. Chapter 7 continues the historical narrative for Hong Kong into the post-war period, including the suspension of the currency board in 1972 and the substitute policies which were pursued

in its place. Chapter 8 gives a detailed account of both the initial structure of Hong Kong's currency board when it was re-introduced in 1983 and the various administrative changes which have taken place since then. Chapter 9 provides an analysis, also in considerable detail, of the operation and performance of the system since 1983. Chapters 10 and 11 then focus on the institutional arrangements of, respectively, the Hong Kong Monetary Authority and the Exchange Fund. Chapter 12 offers an overall summary assessment of the performance of the currency board since 1983. Finally, Chapter 13 looks briefly at Hong Kong's wider economic performance over that period.

Several annexes are included. Annexes A and B reproduce some of the important legal and administrative texts which govern monetary policy in Hong Kong. Annexes C and D elaborate two key aspects of monetary analysis, namely the way in which banks can create money, and the distinction between sterilised and unsterilised intervention in the foreign exchange market. Annex E goes on to describe how the Hong Kong authorities, though able to conduct both types of intervention, have always adhered strictly to the conventions of the currency board. Annex F reviews some of the latent problems presented by the particular administrative arrangements adopted for note issuance in the early years after the re-introduction of the currency board in 1983. Annex G provides a summary chronology of the main administrative measures since 1983.

A Snapshot of the Present System

Current arrangements

Hong Kong today operates its monetary regime according to the following rules and principles.

Objective

To maintain the exchange rate against the US dollar at close to 7.80 via a currency board mechanism.

Operational strategy

'Stock' rule: the monetary base must at all times be fully backed by US dollars at the rate of 7.80. 'Flow' rule: any increases/decreases in the aggregate monetary base must be matched by equivalent transactions against US dollars with the Exchange Fund at intervention rates in the range 7.75–7.85 in the case of banks' balances, or at 7.80 in relation to certificates of indebtedness.

Operational mechanisms

Certificates of indebtedness, which the note-issuing banks are obliged to hold as exact backing for their banknote issue, are bought by them from the Exchange Fund against payment in US dollars at the rate of 7.80 when the note issue expands, and redeemed for value in US dollars at the rate of 7.80 when the note issue contracts.

At any time a bank may have Hong Kong dollars credited to its settlement account at the Exchange Fund by selling US dollars to the Fund at the rate of 7.75. At any time a bank may acquire US dollars from the Fund by selling Hong Kong dollars to it at the rate of 7.85, but only to the

extent that it has the necessary Hong Kong dollar funds in its settlement account, or can obtain such funds through repo transactions with the Fund.

The Hong Kong Monetary Authority (HKMA) may at its discretion execute HK\$/US\$ exchange transactions with banks, in either direction, for Hong Kong dollar settlement across the banks' settlement accounts, at rates inside the range of 7.75 to 7.85.

A bank may carry out repos with the Exchange Fund during the course of the business day to cover shortfalls in its settlement account arising from the interbank settlement process. No interest is charged. If a debit balance on the account is not cleared by the end of the day, the bank must cover it by, effectively, borrowing overnight from the Fund — through the mechanism of repos in Exchange Fund bills or notes. Such borrowings are subject to an interest charge according to the discount rate formula.

Empowerment

Since the reversion of Hong Kong to Chinese sovereignty in 1997, the overarching constitutional authority for Hong Kong to run its own monetary policy has rested in the Basic Law (see Annex A).

The legal basis for the holding of certificates of indebtedness by the note-issuing banks was already enshrined in the Exchange Fund Ordinance, enacted in 1935, but the arrangement whereby the note-issuing banks paid for the certificates in foreign currency (sterling at that time) was an administrative agreement rather than a statutory requirement. This continued to be the case when the currency board was reinstated in October 1983, with the note-issuing banks merely agreeing *de facto* to readopt the currency board system, now based on the US dollar.

However, in May 1984 the statutory basis for the currency board was for the first time formalised by an amendment to the Exchange Fund Ordinance which empowered the Financial Secretary statutorily to specify the currency in which transactions in certificates of indebtedness were to be settled (even though their denomination remained Hong Kong dollars) and, in the event of a foreign currency being specified, to specify also the applicable rate of exchange. Since then, the specification has remained US dollars at the exchange rate of US\$1=HK\$7.80 (see Annexes A and B).

Another important statutory element of the monetary structure is the requirement, since 1996, under the Banking Ordinance, that every licensed bank should maintain a settlement account at the Exchange Fund.

The monetary regime was further formalised in 2003, when the Financial

Secretary confirmed to the Monetary Authority, for the first time in a published written instruction, that the monetary policy objective was to maintain the exchange rate against the US dollar stable at around 7.80 within a currency board framework, and made it clear that responsibility for meeting that objective lay squarely with the Monetary Authority (see Annex B).

Within that framework, the Monetary Authority itself sets the parameters for its intervention in the foreign exchange market (other than that relating to certificates of indebtedness), and has altered them from time to time. The present arrangement of the 7.75–7.85 range dates from May 2005. The Monetary Authority also determines the formula by which its base rate is calculated, and hence the discount rate paid by banks when conducting any repos with the Exchange Fund in order to keep their settlement accounts in credit. In both these instances, although the arrangements are, formally, administrative decisions for the HKMA to decide, the HKMA would in practice consult the Exchange Fund Advisory Committee, via the Financial Secretary, before making any substantive changes.

Ancillary arrangements

Exchange Fund bills and notes are, as the name implies, issued by the Exchange Fund. Payments for them, as well as interest payments and the eventual redemption proceeds, are all ultimately settled across the accounts of banks at the Fund. The securities are mostly held by banks, since they are the principal ones which the HKMA accepts in its repo transactions. Because they are readily convertible into banks' reserve money, they are included in the definition of the monetary base. Thus, their issuance and redemption affects the composition but not the total of the monetary base. The HKMA has made it clear that, for the time being at least, it regards Exchange Fund paper as a means to assist banks with their liquidity management, and does not seek to use it as a macro-monetary policy instrument.

Transmission mechanism for monetary policy

The boxes below illustrate the expected adjustment processes in response to upward or downward pressure on the exchange rate. These are the essence of the currency board system. (Note that a higher number for the exchange rate expressed as Hong Kong dollars per US dollar — e.g. 7.90 rather than 7.80 — implies a weaker Hong Kong dollar, and vice versa.)

Box 2.1 Response mechanism to strong Hong Kong dollar

Excess of market participants wishing to buy Hong Kong dollars
 Upward pressure on Hong Kong dollar
 Market exchange rate strengthens towards 7.75
 When the rate hits 7.75, HKMA buys US dollars at 7.75, crediting Hong Kong dollar proceeds to banks' settlement accounts
 Monetary base expands
 Resultant extra liquidity puts downward pressure on interest rates
 Lower interest rates and abundant liquidity serve as disincentive to holding or acquiring Hong Kong dollars
 Upward pressure on exchange rate therefore abates
 Exchange rate weakens away from the 7.75 limit — back towards 7.80.

Other possible longer-term elements in the monetary adjustment mechanism

Additional liquidity and cheaper credit, if they persisted, would stimulate consumption and investment spending, and prompt inflationary pressure. Any extra spending would feed through to additional demand for imports, while any additional inflation would impair competitiveness. Both these developments would tend to weaken the exchange rate and so assist the equilibrating process.

Box 2.2 Response mechanism to weak Hong Kong dollar

Excess of market participants wishing to sell Hong Kong dollars
 Downward pressure on Hong Kong dollar
 Market exchange rate weakens towards 7.85
 When the rate hits 7.85, HKMA sells US dollars at 7.85, debiting Hong Kong dollars from banks' settlement accounts
 Monetary base contracts
 Tighter liquidity puts upward pressure on interest rates
 Higher interest rates and shortage of liquidity serve as incentive to holding or acquiring Hong Kong dollars
 Downward pressure on exchange rate therefore abates
 Exchange rate strengthens away from 7.85 limit — back towards 7.80.

Other possible longer-term elements in the monetary adjustment mechanism

Tighter liquidity and dearer credit, if they persisted, would dampen consumption and investment spending, and reduce or reverse inflationary pressure. Any reduction in spending would feed through to weaker demand for imports, while any reduction in inflation would benefit competitiveness. Both these developments would tend to strengthen the exchange rate and so assist the equilibrating process.

Performance of the Currency Board

Achieving the objective

In the narrow context of achieving exchange rate stability against the US dollar, Hong Kong's currency board since 1983 has been remarkably successful, as may be seen from Figure 9.1 in Chapter 9.

Once the system had settled down and the worst of the financial jitters over Hong Kong's future had subsided, the rate in the foreign exchange market tended to veer on the strong side of 7.80. This was in part because the authorities and the leading banks shared an asymmetry of attitude.

On the one hand, the major banks generally saw it as in their wider interest to assist in achieving monetary stability, and were accordingly anxious that the 'peg' should be seen to be successful. They, or more specifically HSBC, were therefore often willing to intervene in the foreign exchange market to prevent any significant depreciation beyond 7.80 (e.g. towards 7.82), although they would usually wish to see the authorities prepared to act in parallel. The authorities generally shared this desire to snuff out any weakness, and were also willing to intervene accordingly.

On the other hand, there was less concern among the authorities or the leading banks to stifle any appreciation of the market rate. So long as it did not go so far as to undermine the idea that Hong Kong operated an essentially fixed rate, an exchange rate standing a little on the strong side of 7.80 was seen by some as a virility symbol and by others as a useful means of creating some discomfort for those who might have earlier been speculating on a devaluation of the currency. It also meant that the note-issuing banks profited from the secular expansion of the note issue by being

able to purchase, at a cheaper rate than 7.80, the US dollars which they needed in order to buy certificates of indebtedness.

For those reasons there was generally less urgency to resist appreciation than to resist depreciation. On occasions the rate strengthened to a margin of about 1% (to 7.72).

Notwithstanding that there was no formal convertibility undertaking for banks' balances, even on the weak side, until 1998, there were occasions, especially in the early days, when the stability of the exchange rate, in the face of any pressures, probably owed more to the official provision to the banks of some *de facto* convertibility, via intervention, than it did to any operation of the presumed textbook adjustment mechanism through movements in interest rates.

The bias to the strong side of 7.80 created its own problem, since 7.80 came to be regarded as the extreme point of weakness rather than a central target. During the mid-1990s it became apparent that the authorities were unwilling to allow the rate even to depreciate further than 7.75. The anomaly of having an announced peg at 7.80, but effectively operating a band of roughly 7.72 to 7.75, was partly resolved by the measures of 1998, which resulted in the move to a weak side limit at 7.80. But from time to time thereafter the market rate was persistently on the strong side — in some instances because of speculation on a possible formal revaluation, associated with periods of upward pressure on the Chinese renminbi.

Now, as a result of the measures announced in May 2005, the rate is firmly held within the range 7.75 to 7.85. It traded continuously in the stronger half of the band up until early 2007, mainly because of the belief among some observers that the appreciation of the renminbi against the US dollar would precipitate an upward adjustment of the Hong Kong dollar too. Such suggestions have, however, been persistently refuted by the Hong Kong authorities.

Rules or discretion

The history of the last 23 years shows that, far from being a shining example of the textbook currency board delivering a fixed rate through an automatic adjustment mechanism, Hong Kong's currency board system has witnessed a considerable amount of discretionary intervention — although only a small residual amount of discretion remains exercisable today. The following

paragraphs review the period with a particular focus on the role played by discretionary interventions.

When the currency board was re-adopted in 1983, it was, through force of circumstances, based only on the physical currency. The authorities actively intervened in the foreign exchange market on a sterilised basis — i.e. outside the ambit of the currency board — and, at least in the initial stages, in the money market too, so as to ensure that the market exchange rate held close to 7.80. Without such intervention, divergences from 7.80 would almost certainly have been larger, belief in the ability of the arrangement to deliver exchange rate stability would have faded, and Hong Kong might have been left with a segmented system of an essentially floating market exchange rate in parallel with a restricted market in banknotes. In that event, the 7.80 rate for currency might reasonably have been abandoned as serving little useful purpose, and Hong Kong would have been back at square one. Thus, the discretionary interventions were both necessary and successful.

One might argue that, given such resort to intervention, outside the framework of the currency board, the authorities should have been quicker to introduce the reform which eventually came in 1988, when the Accounting Arrangements were introduced. However, this matter did not receive immediate attention following the introduction of the peg in 1983, because there was a lingering hope that arbitrage pressures between the banknote market and the wider foreign exchange market might somehow deliver convergence. And, even when that hope faded, time was required to negotiate the new arrangement, since it involved a substantial upheaval to the traditional position and role of the leading commercial bank.

The decade from 1988 can be characterised as one during which the basic framework was in place to allow bank reserve money to play its proper role in the currency board process, in terms of convertibility on an unsterilised basis. Yet the authorities chose to leave that mechanism largely in limbo, and instead concentrated on managing interbank liquidity or short-term interest rates.

This choice was motivated partly by the belief that the money market, if left to itself, would not function fully in accordance with free market principles, because of the dominance of a single bank, and partly by fear of the wider economic consequences of interest rate fluctuations, even though such fluctuations should be the essence of adjustment under a currency board regime.

Although this strategy of managing liquidity was fundamentally at odds

with currency board principles, the authorities held firm to the overriding objective of keeping the market exchange rate within close range of 7.80, and they therefore only operated in the money market within the scope which that objective would allow.

As a result, it would be wrong to say that the use of discretion detracted significantly from the goal of exchange rate stability, but at the same time it seems that the discretionary money market interventions might not have been necessary, had the authorities been more willing simply to allow the classical currency board mechanism to be triggered by foreign exchange market intervention once the rate reached the limits of some declared tolerable range.

The authorities waited until the shortcomings of this regime phase became starkly apparent before proceeding, in 1998, with reforms which took the exchange rate regime significantly closer to the concept of a tightly rule-based currency board.

Thus, the 1998 measures brought the system much further into line than hitherto with the principle of the entire monetary base being convertible on the basis of fixed rates, through unsterilised intervention; but not the whole way: discretion was retained in respect of the rate at which any foreign exchange intervention on the strong side would take place. However, discretionary money market intervention was at last discarded, and interest rates were freed up.

Although, over the ensuing years, the remaining strong-side discretion may sometimes have been exploited profitably by the HKMA at the expense of speculators, there is no evidence that, on balance, it assisted underlying exchange rate stability. On the contrary, the absence of an announced intervention point occasionally gave rise to unhelpful rumours about revaluing the peg or abandoning it.

Eventually, in 2005, a strong-side convertibility undertaking was introduced, and the weak-side peg adjusted to provide symmetry around 7.80. This was the penultimate step towards what could be a fully rule-based system in accordance with the purist textbook model of a currency board. But it will only be possible to claim complete adherence to that model if the HKMA takes the ultimate step of surrendering the discretion which it has kept for itself to intervene within the band. It is far from clear why the HKMA needs to retain that discretion, although, once again, it is difficult to argue that it will be damaging.

In sum, the success of the 7.80 peg in the early years certainly owed much to the exercise of discretionary intervention. Yet, whatever the excuses

or explanations may be, twenty-one years seems an inordinate length of time for the authorities to have taken in moving from the rudimentary arrangements of 1983 to the almost entirely rule-based regime reached in 2005. However, in mitigation it may be acknowledged that the retention of significant discretion in the intervening years was not obviously damaging. Having now moved so far in surrendering its discretionary powers, it is something of a puzzle why the HKMA nevertheless sees a need to retain a small discretionary capability (to intervene within the band). Perhaps it is instinctively reluctant to write itself entirely out of the script.

A Brief Look at Economic Performance under the Currency Board

Preceding chapters have recorded the success of the monetary system in delivering exchange rate stability. But what has been the macroeconomic impact? How has the economy performed? And, of potentially greater interest, might it have performed significantly better (or worse) under a completely different monetary regime, such as a floating rate with inflation targeting, as is common elsewhere today?

Performance

An inevitable consequence of a currency board is that, notwithstanding the authorities' efforts to massage interest rates during the years 1983 to 1998, the broad level of rates has to be left to be determined by market forces, and in normal circumstances (that is, when the market is confident that the fixed exchange rate will endure) the pattern of rates will tend to mirror that in the economy of the anchor currency — in this case the United States. The adjustment process of the currency board dictates that when there is upward pressure on the Hong Kong dollar, Hong Kong interest rates will fall below those US rates, and when there is downward pressure, Hong Kong rates will rise above US rates. Thus, for example, during the Asian financial crisis of 1997 and Hong Kong's related confidence crisis of 1998, there were occasions on which HIBOR was sharply higher than LIBOR. And an opposite gap persisted for much of 2002–2003 when, as a result of political and market pressures on the renminbi, there was speculation that the Hong Kong dollar might be revalued against the US dollar, or the peg abandoned and the currency allowed to find its own level.

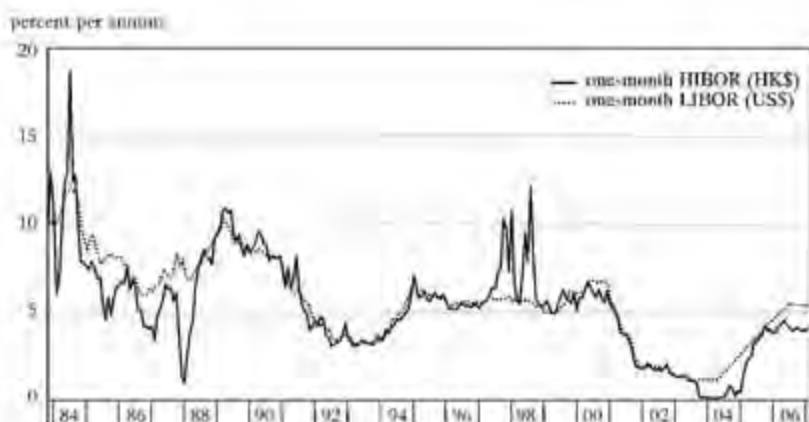


Figure 13.1 Interest Rates

Another feature of the regime is that the authorities therefore have little or no influence over the rate of inflation. This does not mean, however, that the rate of inflation necessarily tracks closely the rate in the economy of the anchor currency. Indeed, as has been the case with Hong Kong and the United States, one might expect some divergence if the two economies are structurally different or at different stages of the cycle. Nevertheless, the discipline of the currency board should ensure that inflation is not wildly at variance with the anchor economy and thus that, assuming the anchor currency to be soundly managed by its central bank, the worst extremes of inflation or deflation will be avoided.

As Figure 13.2 shows, Hong Kong has experienced considerable variation in its inflation rate since 1983, from a high of some 12% in 1991 to deflation of almost 5% in 1999 and 2003. But the tie to the US dollar ensures — again, assuming steady monetary policy from the US Federal Reserve — that neither rapid inflation nor rapid deflation can persist for too long.

With regard to the performance of the economy in terms of real gross domestic product, for much of the period since 1983 the pattern of Hong Kong's growth has mirrored that of the international economy more generally, with, for example, the cyclical ups and downs of the late 1980s and early 1990s. Hong Kong has also benefited, especially in the latter half of the period, from the strength of economic growth on the Mainland.

In addition, Hong Kong's performance has perhaps been accentuated on occasions, in both directions, by the behaviour of real interest rates. The chart of real interest rates in Figure 13.3 (admittedly, rather simplistically

12-month percent
rate of change



Figure 13.2 Hong Kong inflation: Consumer price index (series A)

percent per annum



Note: the real interest rate is calculated here on a quarterly basis as the difference between the quarterly average of 3-month HIBOR (monthly series) and the year-on-year change in the quarterly average of CPI (A) (monthly series).

Figure 13.3 Hong Kong: Real interest rate

calculated on the assumption that people's expectations of inflation are based on the experience of the last twelve months) indicates that the low or negative real rates evident from about 1987 to 1997 may have helped sustain the brisk growth for much of that period, while the strongly positive rates of the period 1999–2002 may have contributed to the weaker economic performance of those years.

Yet there were other factors at work too. Fairly specific to Hong Kong were the Asian financial crisis and the ensuing crisis of confidence in Hong Kong in 1997–98, and the impact of the SARS epidemic in 2002 and the subsequent bounce-back.

annual percent
rate of change



Figure 13.4 Hong Kong: Real gross domestic product

How different might it have been?

What difference, if any, may the currency board itself have made to economic performance? In order to answer such a question one would need, for comparison, to specify an alternative exchange rate regime and replicate how the economy might have performed under such a regime. There is very little available from the research literature by way of empirical investigation to meet that need.

However, a couple of studies are worth mentioning. One, albeit now rather dated, found that the exchange rate stability introduced by the currency board served to reduce volatility in the real economy.⁶⁷ Another simulated alternative regimes where interest rates were adjusted according to some so-called Taylor-type rule, or in order to achieve relative stability of the trade-weighted exchange rate along the lines of Singaporean practice. It was found that both alternative policy regimes would have led to lower inflation in Hong Kong before the Asian financial crisis and less severe deflation thereafter, but that, in terms of the output of the economy, Hong Kong probably fared better under its currency board regime than it might have under the alternatives.⁶⁸

More generally, the Hong Kong authorities, supported by much local opinion, have tended to argue that, because Hong Kong is such an open economy and would, with its open financial system, be singularly vulnerable to market volatility if the slightest uncertainty arose over the monetary regime or the authorities' intentions in the monetary sphere, it is best served by a clearly defined, transparent, rule-based system, carrying minimum scope for political or administrative interference. Thus the relative merits of the currency board may be stronger in the case of Hong Kong than for most other jurisdictions. It may also be noted that inflation targeting — the norm for many other economies — might be more difficult for Hong Kong because of the highly open nature of the economy.

Meanwhile, the flexibility of the Hong Kong economy means that the pain of any adjustment to shocks is likely to be less than would be the case in other economies seeking to sustain a fixed rate in the face of similar shocks.

The yuan question

No discussion of possible alternative regimes would be complete without mention of the idea of fusing the Hong Kong dollar with the Chinese yuan (renminbi). This idea may enthuse some, simply as a patriotic gesture; but patriots, above all, cannot ignore the Basic Law (effectively Hong Kong's constitution), and that clearly specifies that Hong Kong has its own separate currency and is in charge of its own monetary policy.

If the proponents accept that constraint, they may argue, nevertheless, for locking the Hong Kong dollar to the yuan firmly — perhaps at a rate of one-to-one — instead of locking to the US dollar at 7.80. This could be

done, although for the time being it would not be possible to do so in a strict currency board fashion, because the yuan is not a fully convertible currency and Hong Kong is not, under current Mainland rules, allowed to hold the yuan securities which would need to be held as backing for Hong Kong dollar money.

But would permanent parity really be a good idea? Structural differences between the two economies require some adjustment in relative prices. Some of this is occurring as a result of the yuan's appreciation against the Hong Kong dollar, and more may be expected in that way. If that is halted, the adjustment of relative prices might have to come via deflation in Hong Kong — a possible and workable adjustment route, as was seen in the period 1999–2004, but not necessarily the preferred one.

Moreover, what will happen to the yuan when it eventually becomes fully convertible? Most people presume that it will appreciate. But, given the probable pent-up demand on the Mainland to acquire foreign assets, it could perhaps depreciate. And how stably managed will it be, given that Beijing has no experience of operating a convertible currency? Would Hong Kong wish to be locked into the attendant uncertainty, surrendering the known stability of the US Federal Reserve's timeless strategy? Probably not, and Hong Kong officials have made it clear that no change is contemplated for the time being in the monetary regime, and have affirmed that full convertibility of the yuan would, at the very least, be a prerequisite for any consideration of linking the Hong Kong dollar to it.⁴⁰

Conclusion

The overall stability of the exchange rate at close to 7.80 for almost a quarter century is proof enough of the success of Hong Kong's monetary regime in meeting the declared exchange rate objective. In the final analysis, it may not matter very much that, in meeting their objective, the authorities did not always adhere to currency board 'best practice', or that they were rather slow in moving towards it.

Both the limited empirical evidence and *a priori* argument suggest that a currency board regime may be particularly well suited to Hong Kong. Although there is no proof that economic performance has thereby been optimised, equally there is no proof that any particular alternative regime would have served Hong Kong any better. Despite occasional calls, usually

during the more difficult economic episodes, for the system to be abandoned, no-one has yet come up with clinching arguments in support of a specific alternative. Closer association with the yuan might be desirable or advisable at some stage, but certainly not until the Mainland authorities have established a satisfactory track record in managing a fully convertible currency, and also probably not until the two economies are structurally aligned more closely than they are today.

Notes

- ¹ Andrew B. Abel and Ben S. Bernanke, *Macroeconomics* (Boston: Addison-Wesley, 2001), p. 248.
- ² For instance, if bank A owes money to bank B, bank A will settle by transferring funds from its balance at the central bank to bank B's balance there.
- ³ Bank of England governor Mervyn King, Mais lecture, 17 May 2005 (www.bankofengland.co.uk).
- ⁴ The current application of these rules in Hong Kong was itemised in Chapter 2.
- ⁵ In practice there may be a small buy-sell spread, as in Hong Kong with the 7.75–7.85 band, but for ease of exposition here a single rate is assumed.
- ⁶ If sterling notes were used in the colony, they had to be bought from the Issue Department of the Bank of England with funds which would then be invested to earn a profit for the Bank of England (which was then handed over to the UK Treasury). When a colony issued its own notes, the local colonial administration would itself earn the profit from the sterling investments which it held as backing. The profit arising in this manner is commonly referred to as seigniorage.
- ⁷ For example, official statistics show significant falls in Hong Kong payroll per person in recessions, which are less evident elsewhere, although comparisons with other countries are complicated by the nature of available pay data and the varying intensity of recessions. An analysis of the pressures forcing Argentina to abandon its currency board shows significantly less internal price flexibility there than in Hong Kong; see Tony Latter, "Why blame the peg?", *HKMA Quarterly Bulletin*, May 2002.
- ⁸ Senator Pittman from Nevada.
- ⁹ Professor Edwim Kenmerer of Princeton University, who was much involved in advising on currency regimes around the world and had acquired the nickname of 'the money doctor'. His report on China is available in the Princeton University archive.
- ¹⁰ In the light of the soaring note premium in 1929 the tax on HSBC was thenceforth confined to the first \$45 million of its issue.

- ⁽¹⁾ Index of wholesale prices, 1922=100.

1913	1922	1924	1931	1932	1933	1934	1935	1936	1937	1938	1939	1940
64.0	100.0	106.8	136.6	122.4	103.5	91.5	77.9	103.1	131.1	130.6	128.0	173.3

Source: Hong Kong *Blue Book* for 1931 and subsequent years.

- ⁽²⁾ *Report of Currency Committee*, Hong Kong Government, 1930.
- ⁽³⁾ *Hong Kong Currency, Report of the Commission*, London, 1931, Cmd 3932.
- ⁽⁴⁾ *Report of the Commission appointed by His Excellency the Governor of Hong Kong to Enquire into the Causes and Effects of the Present Trade Depression in Hong Kong and Make Recommendations for the Amelioration of the Existing Position and for the Improvement of the Trade of the Colony, July 1934–February 1935*, Government Printers, Hong Kong 3/1935, p. 103.
- ⁽⁵⁾ Colonial Office Currency Committee, minutes of 26 October 1934, Bank of England archive OV44/103.
- ⁽⁶⁾ As reported in the Colonial Office Currency Committee, 2 May 1935, Bank of England archive OV44/103.
- ⁽⁷⁾ According to the *Report of the Commission* (1935, op. cit., p. 103), there was an immediate rise in the (semi-official) Hong Kong–Shanghai inter-port cross rate of some 12%.
- ⁽⁸⁾ Records of meetings at the UK Treasury on 4 and 7 November, Bank of England archive OV44/104/538/73.
- ⁽⁹⁾ Bank of England archive OV44/104/96.
- ⁽¹⁰⁾ Bank of England archive OV44/104/98.
- ⁽¹¹⁾ Telegram, Washington to London, Bank of England archive OV44/104/72.
- ⁽¹²⁾ Reported in telegram, Washington to London, Bank of England archive OV44/104/107. In fact, all the silver was sold on the market in the course of the following year without noticeable impact on the price.
- ⁽¹³⁾ *Laws of Hong Kong*, Chapter 66.
- ⁽¹⁴⁾ *Hong Kong Hansard* 1935.
- ⁽¹⁵⁾ Copies of the accounts for the early years are in the Bank of England archive.
- ⁽¹⁶⁾ The units are (old) pence (d). In various documents the rate is quoted in shillings and pence, there having been 12 pence to a shilling, but, for convenience here, the amounts are expressed in pence only.
- ⁽¹⁷⁾ *Hong Kong Administration Report* 1935.
- ⁽¹⁸⁾ The Attorney General had announced to the Legislative Council that these rates would not be published; see *Hong Kong Hansard* 1935, p. 250. It was not until September 1939 that a formal announcement was made to the effect that the Exchange Fund would exchange sterling with the note-issuing banks at those particular rates; see *Administration Report* for 1939. Later the redemption rate was raised to 14%*ad*. Subsequently, in 1965, the government agreed that the buy/sell spread should not apply to the ebb and flow of note circulation precipitated by bank runs, and in 1967 that it should similarly not apply to the seasonal surge around the Chinese New Year. The spread was dropped by administrative

arrangement in 1969, and would anyway have ceased to have any relevance once the Hong Kong dollar became the vehicle of payment for certificates of indebtedness in 1972. The spread was not resurrected when US dollar payments were introduced in 1983 — certificates of indebtedness have, since then, been both purchased and redeemed at the same 7.80 rate.

²⁹ *Hong Kong Hansard*, 1972–73, pp. 218–29.

³⁰ *Ibid.*, p. 224.

³¹ Afterwards the assets of the Exchange Fund were diversified quite rapidly, with the sterling proportion falling to 53.9% by the end of 1974 and to 16.5% by the end of 1976.

³² *Hong Kong Monthly Digest of Statistics*.

³³ The practice developed of banks offering US dollar denominated term deposits linked to foreign exchange swap contracts (spot purchase and forward sale of US dollars by depositing customers); the interest rate on foreign currency deposits was not covered by the Hong Kong Association of Banks (HKAB) rules.

³⁴ For example, via the portfolio channel: purchasers of foreign exchange would gradually have their demand sated.

³⁵ The first admission of this problem, and of the fact that it was linked to the revised arrangements of 1972 for certificates of deposit, appears to have been in the Financial Secretary's (Haddon-Cave) statement to the Legislative Council in 1978: "since the middle of 1972, Certificates of Indebtedness have been issued against the creation of Hong Kong dollar deposits and, particularly since the floating of the Hong Kong dollar in November 1974, it has not always been possible to use these Hong Kong dollars to acquire foreign currency assets because of the virtual certainty of the foreign exchange market being disturbed" (*Hong Kong Hansard*, 1978, p. 208).

³⁶ As also confessed by Haddon-Cave: "at 31 December [1978], the Government's Hong Kong dollar balances at \$5,800 million represented nearly 9% of total bank deposits and, indeed, would have been much higher, but for certain arrangements we were able to make during 1978 with the note-issuing banks to acquire foreign currency assets outside the market. . . . The relative importance of our Hong Kong dollar balances and the rate at which they have increased suggest that the Government has involuntarily contributed to the undesirable growth rates of the money supply and bank advances . . ." (*Hong Kong Hansard*, 1979, p. 550).

³⁷ The scheme became formally redundant only when the Accounting Arrangements were introduced in 1988.

³⁸ See Chapter IX, "The Hongkong Bank — The ultimate survivor", in Leo Goodstadt, *Uneasy Partners: The Conflict between Public Interest and Private Profit in Hong Kong* (Hong Kong: Hong Kong University Press, 2005), pp. 181–93.

³⁹ Yum K. Kwan and Francis T. Lui, "Hong Kong's currency board and changing monetary regimes", in *Changes in Exchange Rates in Rapidly Developing Countries*, ed. Takatoshi Ito and Anne O. Krueger (Chicago: University of Chicago Press, 1999).

- ⁴⁰ Y. F. Luk, *Money and Prices Without a Central Bank — The Case of Hong Kong, 1974–83* (Cornell University, reproduced by University Microfilms International, 1991).
- ⁴¹ These adjustment processes were summarised in Chapter 2.
- ⁴² An exception was the money market intervention scheme, described in Chapter 7.
- ⁴³ The debate can be found in Y. C. Jao, "Intervention replaces arbitrage — the July package of monetary measures: A comment", *Asian Monetary Monitor*, November–December 1988; and J. G. Greenwood, "Intervention replaces arbitrage — the July package of monetary measures", *Asian Monetary Monitor*, July–August 1988, and "Response to Dr Jao", *Asian Monetary Monitor*, November–December 1988.
- ⁴⁴ See record of meeting of the Currency Board Sub-committee of the Exchange Fund Advisory Committee, 5 March 2004.
- ⁴⁵ "Strengthening the currency board arrangements in Hong Kong", HKMA *Quarterly Bulletin*, November 1998.
- ⁴⁶ Initially certain other securities were also eligible for such repos, but these are no longer significant.
- ⁴⁷ The scope of the commentaries which follow is partly constrained by the limited availability of information; see the note on Further Reading.
- ⁴⁸ In the early stages, some potential problems arose from the administrative arrangements which the note-issuing banks put in place for supplying notes to the other banks. However, the difficulties did not materially affect the currency board in macro terms, and are not therefore further discussed in this chapter. Details can, however, be found in Annex F.
- ⁴⁹ See "Why the HK\$/US\$ linked rate system should not be changed", *Asian Monetary Monitor*, November–December 1989.
- ⁵⁰ Within this period the author was himself intimately involved in Hong Kong's monetary management until April 1985.
- ⁵¹ See Chapter 7.
- ⁵² See, for example, "Core principles for systemically important payment systems", Bank for International Settlements, Committee on Payment and Settlement Systems, publication no. 43, January 2001.
- ⁵³ *First Quarter Economic Report*, 1990.
- ⁵⁴ HKMA *Quarterly Bulletin*, November 1994.
- ⁵⁵ "Management of interbank liquidity", HKMA, *Quarterly Bulletin*, November 1994.
- ⁵⁶ As reported in the section "Operation of monetary policy" in successive *Quarterly Bulletins*.
- ⁵⁷ Both quotations from "The interest rate structure in Hong Kong", HKMA *Quarterly Bulletin*, November 1994.
- ⁵⁸ HKMA *Quarterly Bulletin*, May 1995.
- ⁵⁹ This loophole was later closed by the measures of September 1998.

- ⁶⁰ Reproduced in the *Quarterly Bulletin*, May 1998.
- ⁶¹ For an account of these events, see “Operation of monetary policy” and “Why we intervened”, HKMA *Quarterly Bulletin*, November 1998.
- ⁶² See Annex A.
- ⁶³ HKMA Annual Report 2006, p. 93.
- ⁶⁴ *Ibid.*, p. 94.
- ⁶⁵ *Ibid.*, p. 96.
- ⁶⁶ For an account of that episode, see “Why we intervened”, HKMA *Quarterly Bulletin*, November 1998.
- ⁶⁷ Mark Crosby, “Exchange rate volatility and macroeconomic performance in Hong Kong”, Hong Kong Institute for Monetary Research, working paper 03/2000, June 2000.
- ⁶⁸ Petra Gerlach-Kristen, “Internal and external shocks in Hong Kong: Empirical evidence and policy options”, Hong Kong Institute of Economics and Business Strategy, working paper 1086, May 2004.
- ⁶⁹ As stated, for example, by the HKSAR Chief Executive, Donald Tsang, in a Chinese-language radio interview on 19 May 2006, reported in English by *The Standard*, 20 May.

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