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Should Hong Kong maintain a linked exchange rate system?

Tsoi Hoi Yin

Abstract
The linked exchange rate was implemented in 1983. This paper finds that over these 32 years, this system did bring lots of benefits to Hong Kong. Nevertheless, as Hong Kong is a vastly different place now relative to what it was 32 years ago, the costs for the adoption of the link outweigh the benefits so this system is no longer suitable for Hong Kong. It is suggested that in order to serve the best interest of Hong Kong, it should not maintain the linked exchange rate system and should switch to the managed floating exchange rate system.

Key words: Hong Kong, linked exchange rate system, the US
1. Introduction

As an international financial centre, Hong Kong needs to have an open and highly externally oriented economy, where one of its most important tools is a stable exchange rate. The linked exchange rate system was established on October 17th of 1983, as a consequence of the financial turmoil after several rounds of Sino-British negotiations about the Hong Kong's future, which at the time was adopting a floating exchange rate regime. To restore public confidence in the currency, the Hong Kong dollar was pegged to the US dollar at the rate of HK$ 7.8 = US$1 in 1983, and it has worked basically the same way until now, and the reason for this is because the authorities believe that it is right to stabilize the value of the Hong Kong dollar against the major currencies in the world.

“Whatever exchange-rate system a country has, it will wish at some times that it had another one,” according to Stanley Fischer, a former central banker.\(^\text{14}\) Since Hong Kong has established the linked exchange rate system for over 30 years, with the rapid changes in the economic environment, the country and the global economy have been involved in a series of changes, therefore it sparks heated debates over whether it is time to adjust Hong Kong’s exchange rate system.

This paper will examine whether the linked exchange rate regime is suitable for Hong Kong in response to the changes in the economic environment. It will be directed in five parts. Part 2 will be an overview of Hong Kong’s exchange rate arrangement. Part 3 will explain the operation of the linked exchange rate system. The benefits and costs for the adoption of the link will be analyzed in detail from the financial activities perspective in part 4. In response to the limitations of the linked exchange rate system, part 5 will discuss the alternative exchange rate systems for Hong Kong and my recommendations on Hong Kong’s future exchange rate system. This paper will be ended with the conclusion in part 6.

2. An overview of Hong Kong’s exchange rate regime

Prior to the implementation of the linked exchange rate system in 1983, there were several major changes on the exchange rate system.

According to the article HKMA Background Brief No. 1 Hong Kong's Linked Exchange Rate System₁⁵, in 1863, a declaration was made by the Hong Kong government that the silver dollar will be used as the legal tender for Hong Kong. Starting to work since 1866 using a Hong Kong version of the silver dollar until 1935, where a new system started to work.

In December of 1935, during the world silver crisis, the government decided to migrate to a more suitable system, linking the currency to the sterling at the rate of one pound to HK$16. Under the Currency Ordinance of 1935, banks were required to surrender the reserve assets in sterling pounds to the Exchange Fund which was a newly formed agency. The note-issuing banks were required to give sterling pounds to the Exchange Fund in exchange for Certificates of Indebtedness which served as legal tender backing for all banknotes. It became in effect a Currency Board system.

Devaluations of sterling on the late 1960s caused a great exchange loss to the Exchange Fund. As a consequence, in June of 1972 the Hong Kong government decided to link the Hong Kong dollar to the US dollar. At the beginning, it was linked at the rate of HK$5.65 to US$1 and the note-issuing banks can buy Certificates of Indebtedness with Hong Kong dollars. Then, from February 1973 the rate became HK$5.085 to one US dollar.₁⁶

However, the US dollar also became a weak currency. The Hong Kong government found it hard to maintain the existing fixed rate with the US dollar, in particular after a global speculative attack on that currency. Consequently, the Hong Kong government allowed the Hong Kong dollar to float freely in November 1974.

Even though it went fairly well for the first two years, the floating exchange rate regime did not work very well after this period. The Hong Kong dollar experienced depreciation due to many factors, such as widening trade deficit, higher interest rates abroad, an over-rapid expansion of the money supply and bank credit. The conventional wisdom at that time was that under a floating exchange rate system, the external imbalances of a country were corrected by adjustments in the exchange rates. The government was seen to be free to pursue independent fiscal and monetary policies to maintain internal balances. Yet, judging from the evidence, the monetary policy of the Hong Kong government (through changes in the levels of interest rates) was not a success. It failed to control the growth of money and credit. Accordingly, this period was highly volatile. Real GDP growth decreased to 0.3% in 1975

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₁⁵ HKMA Background Brief No. 1 Hong Kong's Linked Exchange Rate System (Second edition) . Hong Kong Monetary Authority  http://www.hkma.gov.hk/media/eng/publication-and-research/background-briefs/hkmalin/full_e.pdf

₁⁶ HKMA Background Brief No. 1 Hong Kong's Linked Exchange Rate System (Second edition) . Hong Kong Monetary Authority  http://www.hkma.gov.hk/media/eng/publication-and-research/background-briefs/hkmalin/full_e.pdf
and climbed to around 16% after one year. Inflation rate was 2.7% in 1975 but it rose sharply to 15.5% on 1980. The value of the Hong Kong dollar changed from HK$5.13 in 1981 to HK$6.5 at the beginning of 1983.17

2.1 Reasons for the implementation of a linked exchange rate system in Hong Kong

The speculative attacks and the escalating confidence crisis over Hong Kong’s future in 1982-83 led to a further depreciation of the Hong Kong dollar. During the deadlock of Sino-British negotiation, investors become more anxious about Hong Kong’s future in 1997, leading to a loss of confidence in the local currency, leading to its value to fell sharply. This came to a climax on September 24th of 1983 after a significant decline of Hong Kong dollar in the period of just two days, reaching its lowest level of HK$9.60 in September 1983.18

In order to cope with the currency panic, on October 17th of 1983 the government introduced a new policy to stabilize the currency. It becomes the foundation of the current monetary system in Hong Kong: the link between the Hong Kong dollar to the US dollar at the rate of HK$7.8 to one US dollar.

3. The linked exchange rate system in Hong Kong

Hong Kong’s linked exchange rate system is a currency board system. It requires both the stock and flow of the monetary base to be fully backed by foreign reserves. This means that when there is any change in the monetary base, it must be fully matched by a corresponding change in foreign reserves at a fixed rate of HK$7.8=US$1. The monetary base in Hong Kong composes of:

(1) Certificates of Indebtedness(as backing for the banknotes issued by the three note-issuing banks, namely the HSBC, the Bank of China and the Standard Chartered Bank) ;
(2) The banknotes (HK$10 banknotes) and coins issued by government in circulation ;
(3) The sum of the licensed banks’ clearing accounts balances (known as Aggregate Balance) held in the Hong Kong Monetary Authority (HKMA) ;
(4) The outstanding amount of Exchange Fund Bills and Notes (which are issued by the Hong Kong Monetary Authority. 19

17 HKMA Background Brief No. 1  Hong Kong’s Linked Exchange Rate System (Second edition) . Hong Kong Monetary Authority http://www.hkma.gov.hk/media/eng/publication-and-research/background-briefs/hkmalin/full_e.pdf
18 HKMA Background Brief No. 1  Hong Kong's Linked Exchange Rate System (Second edition) . Hong Kong Monetary Authority http://www.hkma.gov.hk/media/eng/publication-and-research/background-briefs/hkmalin/full_e.pdf
3.1 The operation of the linked exchange rate system in Hong Kong

In order to maintain the linked exchange rate between Hong Kong dollar and the US dollar, the following factors are required:

Firstly, the Hong Kong government must maintain economic discipline and full reserve back up for the issuance of Hong Kong dollar. In the case of banknotes issued by the note-issuing banks, when the note-issuing banks issue new banknotes, they will pay the Exchange Fund in US dollars at the rate of HK$7.8 to US$1 to purchase Certificates of Indebtedness. Hence, the banknotes are fully backed by US dollars. On the other hand, when Hong Kong dollar banknotes are withdrawn from circulation, the note-issuing banks will surrender Certificates of Indebtedness and the Exchange Fund will give them an equivalent amount in US dollars at the same exchange rate. In the case of government-issued banknotes and coins, they are also backed in US dollars at the same fixed rate. However, the market exchange rate between Hong Kong dollar and the US dollar which the bank customers obtain continues to be determined by market forces. Therefore, there are two exchange rates between Hong Kong dollar and US dollar: the linked rate and the market rate.

Secondly, in these circumstances, two automatic stabilizers are needed to force the market rate to move towards the linked rate. The first one is “specie flow” or an “automatic interest rate adjustment mechanism”. It means that for example, due to the lack of confidence in Hong Kong’s exchange rate system, there will be an outflow of capital from Hong Kong, leading to a depreciation of the “market rate” of the Hong Kong dollar and the contraction of the money supply, resulting in an increase in interest rate. It can induce a counter flow of funds to drive market exchange rate back to the linked exchange rate. The second one is currency arbitrage. When the market exchange rate deviates from the official rate, the note-issuing banks or the foreign exchange traders will take advantage of the exchange rate differential between the market and the linked rate by exchanging one currency for another at the officially linked rate to make a profit. Thereby, it can force the market rate to move towards the linked exchange rate.

The essential feature for the linked exchange rate system is that it uses market forces to fix the exchange rate, therefor the HKMA has no obligation to intervene.

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4. Evaluation of Hong Kong’s linked exchange rate system from financial activities perspective

In order to evaluate and determine whether the linked exchange rate system is suitable for Hong Kong or not, we must first look at the characteristics of Hong Kong’s economy: (1) International financial centre, (2) small open economy, (3) large financial sector, and (4) depends on trade.

4.1 The benefits for the adoption of the linked exchange system

1. The first benefit is that the linked exchange rate system can enhance public’s confidence towards the Hong Kong dollar which is crucial for Hong Kong as an international financial centre. The link can enhance public confidence on the Hong Kong dollar because it is a currency board system which requires that the Hong Kong government every time that issues Hong Kong dollars they must be fully (100 percent) backed by the reserve. This implies that all the liabilities on HKMA’s balance sheet, for purpose of issuing Hong Kong currency, will be fully matched by the assets in the Exchange. In addition, in order to support the linked exchange rate system, Hong Kong government possesses a huge foreign currency reserves, that is even classified as one of the highest levels in the world, reaching a the amount of US$332,524 million on February 28th of 201523. Undoubtedly, this requirement can enhance public confidence towards the Hong Kong currency, because the depositors and investors know that when they hold the Hong Kong dollar no matter in which form (notes or coins), the government will have assets with at least an equivalent value to back it up. As a result, the chance for the Hong Kong dollar to face currency panic or nervousness will be greatly reduced and the value of Hong Kong dollar can be stabilized.

In fact, there is a good reason for the Hong Kong government to implement the linked exchange rate system in 1983. At the beginning of that year Hong Kong was working with the floating exchange rate system. During the several rounds of Sino-British negotiation, people worried about the future of Hong Kong conducting to a deterioration of the economy. The Hang Seng Index dropped drastically by over 30%, from approximately 1,100 in July to 758 at the end of September24. There was a severe selling pressure on the Hong Kong dollar. This came to a climax on September 24th of 1983 where it depreciated to the record low level of HK$9.6025 and The Hong Kong dollar against the US dollar depreciated by 15% in one

\[ \text{Data provided by Hong Kong government} \]
\[ \text{http://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2015/20150331e5a1.pdf} \]
\[ \text{23 Chan, Norman T.L. “The Linked Exchange Rate System – 30 Years On”, insight, 14 October 2013,} \]
\[ \text{24 HKMA Background Brief No. 1 Hong Kong's Linked Exchange Rate System (Second edition). Hong Kong Monetary} \]
and a half working days. As mentioned by the former Chief Executive of HKMA Joseph Yam “there were empty shelves in supermarkets as people scrambled in panic to stock up rice and toilet paper”. Under this bad situation, it was necessary for the Hong Kong government to implement the linked exchange rate system on 17 October 1983 to fix the exchange rate of Hong Kong dollar against the US dollar at 7.8. After that, public confidence was restored and the crisis ended.

This system did achieve the objective for maintaining the stability of Hong Kong’s exchange rate. Over these 32 years, despite Hong Kong has experienced several crises and challenges, including the 1987 stock market crisis, the European Exchange Rate Mechanism crisis in 1992, the bursting of the dotcom bubble in 2000, the outbreak of SARs in 2003, and several major crises, including the 1997-98 Asian financial crisis, the 2007-08 global financial crisis and the recent European sovereign debt crisis, the exchange rate of Hong Kong dollar remains fairly stable during these years. Thus, it can definitely establish the credibility toward the system and further enhance public’s confidence towards the Hong Kong dollar.

2. Besides, the linked exchange rate system can help to maintain the stability of Hong Kong economy which is crucial for Hong Kong as an open and highly externally oriented economy. Since Hong Kong is an international financial, trade and commercial centre in the region, it also has a completely open capital account and a large financial sector (The contribution of the Hong Kong’s financial sector to the GDP increased from 12% in 2002 to 16.5% in 2013), putting it in a position to handle a large scale of capital inflow and outflow every day. Additionally, Hong Kong has a large trade sector that the total value of the external trade in goods and services in one year is commensurate with over three times of Hong Kong’s GDP. Under these circumstances, Hong Kong economy is vulnerable to external financial volatility, resulting in the fluctuation of Hong Kong’s exchange rate that could bring adverse effects on Hong Kong economy. For example, if there is a large demand on Hong Kong’s exports or a large capital inflow to Hong Kong, it will lead to the appreciation of Hong Kong dollar. Conversely, if there is a large capital outflow from Hong Kong, which is similar to the reoccurrence on the 1983 crisis, then Hong Kong dollar will
depreciate significantly. On the contrary, with the link exchange rate system, it provides Hong Kong with a firm monetary anchor and it means that Hong Kong dollar will be backed by the US dollar which is a predominant international currency, providing confidence and maintain stability in the Hong Kong’s economy.

3. The linked exchange rate can increase Hong Kong’s competitiveness to successfully compete for being an international financial and trade centre. Stable currency and economy is one of the determinants whether a city or a country can be an international financial and trade centre. The linked exchange rate system enables Hong Kong to have a stable exchange rate which can facilitate trade and financial transactions. The US dollar is the most widely used currency in the world. A vast majority of the Hong Kong’s exports and imports trade and financial transactions are denominated in US dollar. As Hong Kong dollar is linked to the US dollar, so the exchange rate is very stable and fluctuates only within a very narrow limits. As a result, it is beneficial to the exporters, importers and international investors because the foreign exchange risk and transaction costs can be reduced. They can save the costs for hedging against the exchange rate risk. It is also easier for the businessmen to estimate costs and set prices as they do not have to worry about potential losses caused by exchange rate volatility.

John Greenwood, the chief economist of Invesco and the architect of Hong Kong's currency peg in 1983 suggested that “the stable exchange rate provided a favorable environment for Hong Kong to develop into an international trading hub”\(^\text{32}\). It can be proved by the fact that Hong Kong’s external trade grew from 1.9 times of GDP in 1983 to around 4.5 \(^\text{33}\) times recently and the number of employees in the trade sector account represents around 30% of the working population\(^\text{35}\).

Moreover, he also mentioned that “a stable exchange rate provided a platform for our development as a financial centre”\(^\text{36}\), due to when you have a stable exchange rate, it attracts

\(^{32}\) John Tsang, John Greenwood. “30 years on, Hong Kong's dollar peg is still a star performer ”. South China Morning post. Thursday, 17 October, 2013.


\(^{33}\) Global recovery to benefit Hong Kong's trade sector, economists say(2014, Jan 22) South China Morning post


\(^{34}\) John Tsang, John Greenwood. “50 years on, Hong Kong's dollar peg is still a star performer ”. South China Morning post. Thursday, 17 October, 2013.


\(^{35}\) John Tsang, John Greenwood. “30 years on, Hong Kong's dollar peg is still a star performer ”. South China Morning post. Thursday, 17 October, 2013.


\(^{36}\) John Tsang, John Greenwood. “30 years on, Hong Kong's dollar peg is still a star performer ”. South China Morning post. Thursday, 17 October, 2013.


http://commons.ln.edu.hk/ljbfe/vol5/iss1/4
more investors to do the financial transactions in Hong Kong, as they do not need to hedge the currency exposure. It can be proved by the evidence that in these 32 years, the total assets of the banking sector have grown by over 13 times and the stock market capitalization have increased by over 152 times.\textsuperscript{37} Hong Kong is not only the leading international capital market in Asia but also ranked in third position in Global Financial Centres Index for many years.\textsuperscript{38}

There is no doubt that the linked exchange rate system enables the Hong Kong dollar to maintain a stable value against the major world currencies. This stability plays an important role in providing a favorable environment for Hong Kong to be an international trading and financial centre.

\section*{4. The linked exchange rate system can keep the banking system and Hong Kong government economic policy under tight control}

Under the linked exchange rate system, as the Hong Kong banknotes are backed by the foreign reserves, it needs that the Hong Kong government to maintains a huge currency reserves but also to keep a budget balance in the medium term in order to make people feel confident on the system. At the same time it requires that the Hong Kong’s banks cannot be overleverage and that the banking system has to be strong and solvent so that it is able to cope with the interest rates fluctuations, which may occur under this system. The link leads to the government to pursue fiscal prudence and the banking system must be sound and strong. In return, these increase investor’s confidence towards Hong Kong economy and they are more willing to invest in the country.

As mentioned by IMF in 2012, the linked exchange rate system “has generated substantial benefits in terms of monetary and financial stability, built up a stock of credibility over the decades, and kept the real exchange rate of the Hong Kong dollar broadly in line with fundamentals”\textsuperscript{39} which is particularly important to Hong Kong as a small and extremely externally oriented economy and an international financial centre.

\section*{4.2 The costs for the implementation of the linked exchange rate system}

Every monetary system has its own advantages and disadvantages with no exception to the linked exchange rate system. The reason is that according to the Mundell’s (1963) “impossible trinity”, it found that countries cannot have a fixed exchange rate, free movements of capital and an independent monetary policy at the same time. As Hong Kong is

\begin{footnotesize}
\begin{itemize}
    \item \textsuperscript{37} John Tsang, John Greenwood. “30 years on, Hong Kong's dollar peg is still a star performer ’’. South China Morning post. Thursday, 17 October, 2013 \hspace{1cm} \texttt{http://www.scmp.com/comment/insight-opinion/article/1333090/30-years-hong-kongs-dollar-peg-still-star-performer}
    \item \textsuperscript{38} Global financial centres index: \texttt{http://www.zyen.com/index.php?option=com_content&view=article&id=23&Itemid=29}
    \item \textsuperscript{39} Hong Kong government website \texttt{http://www.info.gov.hk/gia/general/201301/18/P201301180259.htm}
\end{itemize}
\end{footnotesize}
an international financial centre and it is impossible for the country to impose capital controls, it has decided to choose to have a free capital movements and a linked exchange rate.

1. One of the major costs for Hong Kong to adopt the linked exchange rate system is that with the loss of independent monetary policy, Hong Kong has less means to defend the economy from external shocks. Under the linked exchange rate system, Hong Kong Monetary Authority cannot practice a monetary policy independent of the one of the US. Hong Kong’s interest rate and money supply should be in line with that in the US and it can only have little control over the monetary policy. This implies that suppose the US adopts an expansionary monetary policy and reduces its interest rate. Then, the price level in the US will increase which will encourage imports but discourage exports. Hence, Hong Kong’s imports from the US will decline but Hong Kong’s exports to the US will rise. Given that the Marshall-Lerner (elasticity) condition is satisfied, Hong Kong will experience a trade account surplus. Moreover, the US will experience capital outflow due to the fall in interest rate while Hong Kong will experience capital inflow, resulting in the capital account surplus. Hence, the US expansionary monetary policy will lead to a balance of payment surplus in Hong Kong. Under this situation, the Hong Kong dollar will be under appreciation pressure. The market exchange rate is higher than the linked rate now, banks will purchase the US dollar in the market and resell the US to the Exchange Fund for arbitrage profit. The stock of foreign exchange reserve in the Exchange Fund will rise which is equivalent to an expansion in Hong Kong’s money supply and domestic interest rate will decrease. As a result, an expansionary monetary policy in the US, leading to the fall of the US’s interest rate is followed by an increase in the money supply in Hong Kong, leading to the decrease in the interest rate in Hong Kong. Thus, it is said that the linked exchange rate system involved a substitution of the US monetary policy for Hong Kong monetary policy because Hong Kong cannot freely control its monetary policy.

2. The link requires Hong Kong to follow the US monetary policy and makes Hong Kong loses the monetary autonomy to achieve price stability and economic growth. The main problem for the link is that the economic cycles of Hong Kong and the US may not necessarily be consistent. The monetary policy carried out by the US to stimulate or cool down their economy may not suit Hong Kong’s economic conditions. This will make Hong Kong’s economy either overheating or in recession. The most typical example is that during 2007-08 global financial crisis, the US Federal Reserve adopted an expansionary monetary policy that is the quantitative easing to stimulate the economy. The low interest rate in the US transmitted to Hong Kong since 2008 at a level of 0.5% (shown in table 1).

40 Trading economics website http://www.tradingeconomics.com/hong-kong/interest-rate
Although there are lots of reasons contributing to the continuous rising of property prices in Hong Kong, as shown in table 2, when the US initiated quantitative easing in 2008, then Hong Kong’s property prices began to soar drastically from that year. Hence, Hong Kong’s low interest rate caused by the US’s monetary policy is certainly one of the important factors creating the asset bubbles and volatility in Hong Kong.

Table 2 Hong Kong property prices

3. In theory, the linked exchange rate system can enhance the stability towards the Hong Kong economy which had already explained in part 4.2. In practice, this system actually makes Hong Kong’s economy becomes more volatile. The reason is that Hong Kong cannot use the monetary policy to support the economy, even if the country is in a financial crisis unless this crisis will expose the exchange rate of Hong Kong dollar to an unacceptable risk level.

The most typical example is the 1997 Asian Financial Crisis. In October 1997, the speculators took advantage of the currency board system to speculate over the devaluation of

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Hong Kong dollar, the reason why is because Hong Kong’s inflation rate was much higher that the once of the US for several years. As the government decided to maintain the linked exchange rate system, it makes the stock markets become more volatile. The Hang Seng Index dropped by 23% between the 20th and 23rd of October.\(^{42}\) The overnight interbank rate shot up to as high as 280\(^{\%}\), where it was seen that the high rate greatly hurt the real economy. Finally, the crisis ended when the Hong Kong government used its huge foreign reserves to intervene the stock and foreign exchange market. Although the linked exchange rate of Hong Kong dollar was defended, the cost to do it was high. **Indeed, the linked exchange rate system makes Hong Kong prone to a higher level of risk to speculative attack.**

This can also be shown by Professor Ho Lok Sang’s findings which will be explained in details as follows\(^{44}\): Firstly, he measured the volatility of the GDP growth rate before and after the introduction of the link. Secondly, he measured the relative volatility of the GDP growth rate before and after the introduction of the link which is defined as the ratio of Hong Kong’s volatility index to a benchmark volatility Index.\(^{45}\) And he also compared Hong Kong with Singapore, where Singapore adopts a managed floating exchange rate system.

Table 3 Results for the indices

<table>
<thead>
<tr>
<th>Volatility and Relative Volatility Indices between Hong Kong and Singapore for 3 Periods</th>
<th>Period 75-82</th>
<th>Period 83-97</th>
<th>Period 98-2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benchmark Countries</td>
<td>1.13949</td>
<td>0.60610</td>
<td>1.26203</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>0.56484</td>
<td>0.59044</td>
<td>1.26212</td>
</tr>
<tr>
<td>Singapore</td>
<td>0.22762</td>
<td>0.45679</td>
<td>0.91651</td>
</tr>
<tr>
<td>Relative Volatility Index HK</td>
<td>0.49570</td>
<td>0.97416</td>
<td>1.00007</td>
</tr>
<tr>
<td>Relative Volatility Index SPR</td>
<td>0.19976</td>
<td>0.75365</td>
<td>0.72622</td>
</tr>
</tbody>
</table>

From the above result, it clearly reveals that Hong Kong is even more volatile after the implementation of the link. In 1975-82, Hong Kong adopted a floating exchange rate system. Although two major oil crises existed, Hong Kong’s volatility index was 0.56. However, in 1983-97 which is a relative calm period, Hong Kong introduced the linked exchange but the

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\(^{44}\) The information and table 3, graph 1,2,3 were provided by Professor Ho Lok Sang in IBF616 Globalization and Financial Market Development lecture.  
\(^{45}\) The volatility index is standard deviation of the annual growth rates in the relevant period divided by the average annual growth rate in the same period. The benchmark volatility index is the average if the volatility indices of Canada, Australia, Japan, South Korea, France, Germany, New Zealand, Malaysia, the UK, the US. In period 1975 to 1982, it included the effects of two major oil crises and one major monetary shock in 1981-82; 1983-1997 is a period of relative calm; 1998-2010 is a period of extreme volatility due to the Asian Financial Crisis, the Subprime Crisis and the Global Financial Tsunami.
index was even high at 0.59. In 1998-2010, it is an extremely volatile period with the Asian Financial Crisis and 2007-08 global financial crisis so the index reached 1.26. However, for Singapore which adopts the managed floating exchange rate system, the country was much less volatile than Hong Kong within these three periods. In particular, in 1998-2010, as Singapore is surrounded by the South East Asia countries which was severely affected by the 1997-98 Asian Financial Crisis, while Hong Kong’s economic activities were mainly related to China who was not severely affected by it, but once you check the volatility index for Hong Kong was 1.26 compare to the one of Singapore’s 0.92. Moreover, graph 1,2, 3 indicate that Hong Kong’s economic growth rate was lower than Singapore after the introduction of the link in 1983.

Graph1 and Graph 2

Graph 3
To sum up, firstly, the loss of independent monetary policy to defend the external shocks is the major costs for the adoption of the link. Hong Kong had to follow the US’s monetary policy, which is a big problem because its economic cycles are not necessarily in tandem to the US. This not only slows down the Hong Kong’s economic performance but also creates economic bubbles. More importantly, the link also exposes the country to speculative attacks which even makes its economy becomes more volatile.

5. Alternative exchange rate systems for Hong Kong

In fact, it is logical for Hong Kong to link to the US dollar in 1983 to the US, as it is still the predominant international currency until now. But since the linked exchange rate system has been established for over 30 years, with the rapid changes in the macroeconomic environment, the costs for the implementation of the link outweigh the benefits. Therefore, in this part, the alternative exchange rate systems will be discussed to determine which policy options is the most suitable for Hong Kong economy.

It is suggested that Hong Kong dollar can be linked to the renminbi because Hong Kong economies are highly integrated nowadays. But this is not beneficial to Hong Kong. Despite of the fact that the internationalization of renminbi is going in a faster pace, the US dollar is already the world’s most widely used currency and more importantly, the renminbi is not fully convertible, implying that the capital movements are restricted. Thus, it is impossible for Hong Kong as an international financial centre to link to a currency which still has a long way to go to be fully convertible.

Besides, it is not suitable for Hong Kong to adopt floating exchange rate system because it would be better for Hong Kong as an international financial centre and trade dependent economy to have an anchor currency. Otherwise, whenever there is large capital inflows and outflows in Hong Kong, it will not only make the exchange rate become more volatile,
causing an adverse effect on Hong Kong’s trade dependent economy but also make the financial market becomes more volatile.

5.1 Recommendations for Hong Kong’s future exchange rate system

From the point of view of the author, in the short run, Hong Kong can continue to adopt the existing system but the current rate can be changed. The reason is that since Hong Kong’s current economy is much stronger and the macroeconomic environment is also different as compared to 1983, hence the exchange rate HK$7.8=US$1 is no longer suitable for the country. Changing the current exchange rate is the best way to reduce the fluctuations caused by the shifting to another exchange rate system.

In the long run, the Hong Kong government should consider abolishing the linked exchange rate and can follow Singapore to adopt a managed floating exchange rate system. Under this managed floating exchange rate system, Hong Kong dollar will be linked to a basket of currencies instead of a fixed rate to the US dollar. The reason for this change is that firstly, Hong Kong will be less exposed to fluctuations in a single anchor currency’s exchange rate (that is the US dollar); secondly, it is impossible for Hong Kong to lose monetary autonomy to defend Hong Kong economy from external shocks in long term because it will make Hong Kong, which is a small open economy and an international financial centre, to be more volatile; thirdly, Hong Kong’s economy is similar to Singapore; both of them are small open economies and international financial centres where Singapore is ranked in the fourth position in the Global Financial Centres Index which is just behind Hong Kong. Additionally, a managed floating exchange rate system will not harm Hong Kong’s trade-dependent economy because from Singapore’s experience, it reveals that in 1997 Asian Financial Crisis, not only Hong Kong can maintain a stable exchange rate but Singapore’s exchange rate also remained stable. The overall economic performance for Singapore is even much better than Hong Kong where the currency is linked to the US dollar. Hence, Hong Kong can enjoy substantial benefits for this change.

Although the system of pegging Hong Kong dollar to a basket of currencies is criticized as being more complex, less transparent and less predictable because HKMA retains the power to adjust the weights of the component currencies. Nevertheless, HKMA make some improvements based on this system. For example, HKMA can disclose all the information to the public on daily basis to increase transparency and public confidence to the system and state clearly that under what situation HKMA will intervene. As a result, when the market is peaceful and clam, it is worthwhile for Hong Kong to consider changing from a linked to a managed floating exchange rate system in the future.
6. Conclusion

The implementation of the linked exchange rate system in Hong Kong is mainly due to political reasons such as the 1983 political uncertainty than from economic reasons. In the past 32 years, this system did achieve its objective of maintaining a stable value of Hong Kong dollar against major currencies in the world, so it could build a public confidence towards Hong Kong dollar and economy. More importantly, the link attracts more businessmen and investors to do trading in the country which helps Hong Kong to compete for being an international financial and trade centre.

Nonetheless, facing the evolving domestic and global economic environment, the costs for the adoption of the link outweigh the benefits, and Hong Kong should decide not to maintain the linked exchange rate system in the long run. Some people may be worry that the switch of the exchange rate system may cause a high volatility to the Hong Kong’s economy. But when we look back to the historical development of the exchange rate system, there were also several changes on the exchange rate system. It tells us that the transition for the exchange rate system may not necessarily cause a huge fluctuation to Hong Kong’s economy as long as the transition is smooth and appropriate. Therefore, it is possible for Hong Kong to consider changing from the linked to the managed floating exchange rate system which is the best way to serve Hong Kong’s long term interests.

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