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Monetary policy can be a contentious matter for any economy. In Hong Kong, our linked exchange rate system, which now enters its eighteenth year of existence, has long been a subject of active discussion. This is not just because it is quite a rare and successful modern example of a currency board in action. It is also because the question of whether there is a better alternative for Hong Kong is always relevant in a rapidly changing and highly dynamic city such as ours.

Under Hong Kong’s linked exchange rate system, the Hong Kong dollar is linked to the US dollar at the fixed rate of HK$7.8 to one US dollar. The link is maintained through the operation of a rule-based currency board system, which ensures that Hong Kong’s entire monetary base is backed with US dollars kept in Hong Kong’s Exchange Fund, one of the largest official reserves in the world. The system is simple, predictable and secure: it has stood the test of time and has survived some stormy episodes – the most recent being the Asian financial crisis of 1997/98.

I am convinced that, for the time being, the linked exchange rate remains the best monetary option for Hong Kong. Whatever short-term gains might be conceivable under another system, no other monetary policy would provide the stability and confidence necessary for an extremely open and externally oriented economy like Hong Kong’s. In an imperfect world, however, no monetary policy is without its costs, and it is right, particularly at a time when Hong Kong is emerging out of a period of intense economic stress, that there should be healthy and informed debate about the link.
The aim of this booklet is to contribute to general knowledge about the link by offering factual information about its origins and operation, and some comment on its benefits and drawbacks. The booklet will, no doubt, be of interest to experts in the field. But I hope that its clear and direct presentation will also appeal to the general reader. *Hong Kong’s Linked Exchange Rate System* is the first in a new series of ‘background briefs’ produced by the HKMA on its key areas of responsibility. Future background briefs will focus on banking, financial infrastructure and other monetary issues. Comments on this work – and suggestions for future topics – are most welcome. Readers with access to the Internet may also wish to take a look at the interactive version of this publication at [www.hkma.gov.hk](http://www.hkma.gov.hk).

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*Chief Executive*  
Hong Kong Monetary Authority  
November 2000
The Hong Kong dollar is officially linked to the US dollar at the rate of 7.8 Hong Kong dollars to one US dollar. This linked exchange rate system, which has been in existence since 17 October 1983, is the cornerstone of Hong Kong’s financial system. The link ensures that the Hong Kong dollar has a stable external value against major world currencies. This stability plays an important part in supporting Hong Kong’s role as a trading and financial centre. The link is maintained through a strict and robust currency board system, which ensures that Hong Kong’s entire monetary base is backed with US dollars at the linked exchange rate. The resources for this backing are kept in Hong Kong’s Exchange Fund, which is among the largest official reserves in the world.

This background brief explains the origins, evolution and workings of Hong Kong’s linked exchange rate system. It also examines how the link is important to Hong Kong’s economy, as well as the limitations that a monetary system of this kind imposes on policy making.
Hong Kong has had a linked exchange rate regime of one kind or another for most of its history as a trading and financial centre.

In 1863 the Hong Kong Government declared the silver dollar – then a kind of international currency – to be the legal tender for Hong Kong, and in 1866 began issuing a Hong Kong version of the silver dollar. The silver standard became the basis of Hong Kong’s monetary system until 1935, when, during a world silver crisis, the government announced that the Hong Kong dollar would be taken off the silver standard and linked to the pound sterling at the rate of HK$16 to the pound.¹

Under the Currency Ordinance of 1935, banks were required to surrender to the Exchange Fund (which was invested in sterling assets) all silver bullion held by them against their banknote issues in exchange for certificates of indebtedness. These certificates were the legal backing for the notes issued by the note-issuing banks under what became, in effect, a currency board system. The note-issuing banks were obliged to purchase the certificates to back subsequent increases in their note issue with sterling.

In June 1972 the British Government decided to float the pound sterling. The Hong Kong dollar was then linked briefly to the US dollar, first at the rate of HK$5.65 to the US dollar, and then, from February 1973, at HK$5.085. But, from June 1972, the note-issuing banks were allowed to purchase certificates of indebtedness with Hong Kong dollars.

In November 1974, against a weakening US dollar, the Hong Kong dollar was allowed to float freely.

¹ For more details about the early monetary history of Hong Kong, see the HKMA publication Money in Hong Kong: A Brief Introduction, November 2000.
Although the first two years went fairly well, the experience of a floating rate regime was not a comfortable one. The then prevailing monetary policy framework was too rudimentary to replace the external monetary anchor. There was no clear monetary policy objective, let alone the tools to pursue such objectives. As a result, this was a period of high volatility on almost all fronts. Real Gross Domestic Product (GDP) growth dropped
to 0.3% in 1975 and climbed to 16.2% in 1976. Inflation swung sharply from 2.7% in 1975 to 15.5% in 1980. The value of the Hong Kong dollar moved from HK$5.13 in 1981 to HK$9.60 to the US dollar in 1983. The depreciation of the Hong Kong dollar was made worse by speculative attacks and by the escalating crisis of confidence over the future of Hong Kong, which came to a head in 1983. The record low point of HK$9.60 in September 1983 was reached after a drop of 13% in just two days.

Facing both a currency panic and nervousness about the soundness of a number of banks, the government announced on 15 October 1983 a new policy to stabilise the currency, which is now the basis of Hong Kong’s monetary system: the link between the Hong Kong dollar and the US dollar at the fixed rate of HK$7.80 to the US dollar.
WHY THE LINK IS IMPORTANT TO HONG KONG

The linked exchange rate system suits the needs of a highly open economy such as Hong Kong’s. It is *simple, consistent and well understood*. It enables Hong Kong to adjust to shocks without the damage and volatility of a sudden currency collapse.

The link *suits Hong Kong’s economic conditions*. Hong Kong is a very externally oriented economy, with a completely open capital account and a large financial sector. The total value of our external trade in goods and services in a year is equivalent to well over 250% of our GDP. These factors leave us heavily exposed to financial shocks stemming from volatilities in external markets. The link provides Hong Kong with a firm monetary anchor which, among other things, reduces the foreign exchange risk faced by importers, exporters and international investors. The choice of the US dollar as an anchor is logical, since it is the predominant foreign currency in which our external trade and financial transactions are denominated.

The effectiveness of the link is helped by *a number of economic attributes* enjoyed by Hong Kong:

*First*, the structure of Hong Kong’s economy is flexible and responsive. Markets such as the labour market, property and retail markets respond quickly to changing circumstances: this flexibility facilitates adjustments in internal prices and costs, which in turn bring about adjustments to external competitiveness without the necessity of moving the exchange rate.

*Secondly*, Hong Kong’s banking system is strong and solvent, and well able to cope with the fluctuations in interest rates which may arise under the linked exchange rate system.
Thirdly, Hong Kong’s government pursues a prudent fiscal policy, with large accumulated fiscal surpluses and a target of budgetary balance over the medium term. Thus there is no fear that the exchange rate system might be undermined by monetary financing of government expenditure.

Fourthly, Hong Kong possesses ample foreign currency reserves for supporting the link. These reserves, held in the Exchange Fund, amounted to US$100.4 billion at the end of August 2000. They are equivalent to over seven times the currency in circulation – one of the highest levels in the world.

Since the establishment of the link in 1983, the Hong Kong dollar exchange rate has remained stable in the face of various shocks. It remained unaffected by the 1987 stock market crash, the Gulf War in 1990, the Exchange Rate Mechanism turmoil in Europe in 1992, the Mexican currency crisis of 1994/95, and the Asian financial crisis of 1997/98.
Hong Kong’s linked exchange rate system is a currency board system, which requires both the stock and flow of the monetary base to be fully backed by foreign reserves. This means that any change in the monetary base is fully matched by a corresponding change in foreign reserves at a fixed exchange rate. In Hong Kong, the monetary base comprises:

- **Certificates of Indebtedness** (which exactly back the banknotes issued by the note-issuing banks) and coins in circulation;
- The balances of the clearing accounts of banks kept with the HKMA (the sum of which is known as the **Aggregate Balance**); and
- **Exchange Fund Bills and Notes**, which are issued by the HKMA on behalf of the government.

Banknotes in Hong Kong are issued by three note-issuing banks. When the note-issuing banks issue banknotes, they are required by law to purchase certificates of indebtedness, which serve as backing for the banknotes issued, by submitting an equivalent amount of US dollars at the rate of HK$7.80 to one US dollar to the HKMA for the account of the Exchange Fund. The Hong Kong dollar banknotes are therefore fully backed by US dollars held by the Exchange Fund. Conversely, when Hong Kong dollar banknotes are withdrawn from circulation, certificates of indebtedness are redeemed and the note-issuing banks receive back an equivalent amount of US dollars from the Exchange Fund. In the case of coins, which are issued by the HKMA, transactions between the HKMA and the agent bank responsible for storing and distributing the coins to the public are also settled against US dollars at the rate of HK$7.80 to one US dollar.

Operating under the currency board system, the only normal circumstances in which the Aggregate Balance varies is when the HKMA responds to the
flow of funds into or out of the Hong Kong dollar. Since September 1998, the HKMA has provided a clear undertaking to licensed banks to convert Hong Kong dollars in their clearing accounts into US dollars at a fixed rate. The convertibility rate for this purpose, which was originally set at 7.75 (having regard to the then prevailing market exchange rate) moved by one pip per calendar day effective from 1 April 1999, and converged with the convertibility rate applicable to the issuance and redemption of certificates of indebtedness at HK$7.80 on 12 August 2000. Since then, this convertibility rate has remained at HK$7.80. The HKMA is also ready to respond to offers by banks to sell US dollars to it in order to replenish their Hong Kong dollar clearing accounts. In deciding whether to accept such an offer, the HKMA will take account of the exchange rate offered, the current level of market interest rates, and prevailing liquidity conditions in the Hong Kong money market.

Under the currency board system, it is interest rates rather than the exchange rate which adjust to inflows or outflows of funds. The monetary base increases when the foreign currency (in Hong Kong’s case, US dollars) to which the domestic currency is linked, is sold to the currency board for the domestic currency (capital inflow). It contracts when the foreign currency is bought from the currency board (capital outflow). The expansion or contraction in the monetary base causes interest rates for the domestic currency to fall or rise respectively, creating the monetary conditions that automatically counteract the original capital movement, while the exchange rate remains stable. This process is very much an automatic mechanism, which does not require the HKMA to exercise any discretion.
To reduce excessive interest rate volatility, a cushion of liquidity is provided by the Discount Window facility, through which banks can obtain overnight liquidity from the HKMA by arranging repurchase agreements using Exchange Fund paper and other eligible securities as collateral. The Base Rate of the Discount Window, which is the interest rate forming the foundation upon which the Discount Rates for repo transactions are computed, is set according to a pre-announced formula that takes into account the US Fed Funds Target Rate and Hong Kong Interbank Offered Rates. The practice of backing Exchange Fund paper by foreign exchange reserves ensures that Hong Kong dollar liquidity created by this process is also automatically backed by foreign exchange reserves in accordance with currency board principles.

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2 Technical details on the operation of the Discount Window are contained in the article “Strengthening of Currency Board Arrangements in Hong Kong”, Hong Kong Monetary Authority Quarterly Bulletin, November 1998.
Hong Kong’s Currency Board system is overseen by the Sub-Committee on Currency Board Operations (under the Exchange Fund Advisory Committee), which meets regularly to monitor the operation of the system and to consider ways of improving it. The Sub-Committee is composed of expert academics, market professionals and senior officials from the HKMA. In keeping with the HKMA’s policy of transparency, the records of the Sub-Committee’s meetings are published, and a large proportion of the papers considered by it are reproduced in the HKMA’s Quarterly Bulletin. The Currency Board Accounts have, since March 1999, been published every month.
The link is the preferred option for Hong Kong, but, like any monetary policy, it has limitations as well as advantages. The linked exchange rate system rules out the use of nominal exchange rate movements as a mechanism of adjustment. Thus, shocks to the economy triggered by external or domestic events, such as sharp depreciations of the currencies of Hong Kong’s competitors or recession in export markets, may necessitate more adjustments of the internal cost/price structure than would be needed if the exchange rate were free to adjust. While such internal adjustment is slower than rapid adjustment by the exchange rate, the process may be accompanied by more durable and necessary structural adjustments within the real economy.

The link ties Hong Kong to US monetary policy at times when the economic cycles of Hong Kong and the US may not necessarily be moving in tandem. A linked exchange rate system leaves little scope for an autonomous interest rate policy to achieve the objectives of price stability or promotion of economic growth. If there is a misalignment between Hong Kong and US economic cycles, local interest rates, which closely track their US dollar counterparts, may not be best suited to the macroeconomic conditions of the domestic economy. For example, an increase in US interest rates to cool down an overheating economy might impede recovery from recession in Hong Kong.

Nevertheless, the flexible economic structure in Hong Kong enables its economy to adapt quickly to changing circumstances. Hong Kong’s economic growth performance has been impressive under the linked exchange rate system over the past 17 years. This is illustrated in the charts opposite.
Limitations Imposed By The Linked Exchange Rate System

Hong Kong Economic Indicators

Exchange Rate

Real GDP Growth

Inflation (Composite CPI)

Unemployment Rate

Trade Balance

Stock Market (Hang Seng Index)
From time to time, and particularly during periods of financial and economic stress, the benefit of the linked exchange rate to Hong Kong is brought into question and alternative exchange rate regimes are proposed. It is right that there should be open and healthy debate on the subject. But how realistic are the alternatives proposed?

**Link to the US dollar but at another rate?**

A one-off change in the exchange rate may arguably shift part of the economic adjustment pressures to the nominal exchange rate, thus alleviating the pain of nominal price and wage adjustments that would otherwise be required. But changing the nominal exchange rate anchor, even only once, would undermine the credibility of the currency board system and invite speculation about the likelihood of further changes in the future. The adverse impact on investor confidence might well trigger a significant outflow of funds, which would pose a threat to economic and monetary stability in Hong Kong. Currency devaluation would also to some extent deflect the economy from the search for productivity gains that would yield longer-term benefits.

**Link to another currency?**

The choice of the anchor currency should take into account the currency denomination of external trade and financial transactions, as well as the credibility and stability of the monetary regime governing that currency. Under the link, Hong Kong has benefited from a largely stable monetary environment in the US and the unparalleled credibility of US monetary policy. The US dollar is also the predominant currency in which our trade and external financial transactions are denominated.
**Link to a basket of currencies?**

By linking to a basket of currencies, the domestic economy would be less exposed to sharp swings in the exchange rate and interest rates of a single anchor currency. But the system would be more complex and much less transparent. To the extent that the monetary authority retained discretion to adjust the weights of the component currencies, transparency and predictability would be reduced, possibly undermining confidence in the exchange rate system.

**Free float of the Hong Kong dollar?**

Under a free floating exchange rate regime, the monetary authority would have a freer hand to pursue an autonomous monetary policy for the purpose of achieving price stability or economic growth objectives. However, Hong Kong is a highly externally oriented economy, and subject to the volatility of international capital flows. Exchange rate fluctuations under a floating rate regime would add uncertainty to the investment and trading environment, and might increase the cost of doing business because of the need to use various instruments to hedge exchange risk. The exchange rate might also, in such an open environment, be liable to overshoot its underlying equilibrium to a damaging degree. With a floating rate, the monetary authority would still need to set a policy framework for monetary stability. This might involve, for example, conducting open market operations to influence interest rates, in pursuit of a target for inflation or the money supply. But it would be difficult to define and execute such a policy with the same clarity, effectiveness and conviction that the linked exchange rate system has achieved.
**Dollarisation?**

Dollarisation means the substitution of the domestic currency by a foreign currency (in most cases the US dollar) as a unit of account, a store of value, and a medium of exchange. If confidence in the domestic currency was severely battered, dollarisation might help stabilise the monetary and financial system.

However, dollarisation would involve significant legal, technical and transitional issues. Resolution of these issues, even if possible, would require considerable time and preparation. There would also be a loss of seignorage (the revenue earned on the reserve assets backing the monetary base). Once implemented, dollarisation would be very difficult to reverse. More important, it would not obviate the need for economic adjustments to the domestic price and cost structure in the event of a negative shock.
There is no single exchange rate regime that is suitable to all economies at all times. Whatever regime is adopted, it must fit consistently into the overall framework of macroeconomic policy. We have examined various alternative regimes, and have concluded that the link is still the best option for Hong Kong. It has served Hong Kong well over the past 17 years and continues to do so.
1. How are local interest rates set in Hong Kong and what is their relationship with their US counterparts?

Interbank interest rates in Hong Kong normally follow closely the movements of their US counterparts under the linked exchange rate system. The size of the interest rate spread between the Hong Kong dollar and US dollar mainly reflects the premium (be it positive or negative) that investors demand on the Hong Kong dollar. Should the interest rate differential get out of line with market expectation, funds will flow to the currency with relatively higher interest rates to reap the arbitrage profits.

Retail interest rates are also determined by market forces (with the current exception of the savings deposit rate, which is determined by the Hong Kong Association of Banks but is expected to be fully deregulated in July 2001). Deposit rates on time deposits are determined by market forces. Likewise, the best lending rate, which is the benchmark interest rate offered by banks on their loans to customers, is subject to commercial decisions by individual banks. Given that interbank funding is a major source of funding for the banking system, retail interest rates will be influenced by movements in interbank interest rates.

2. What distinguishes a currency board system from other forms of pegged exchange rate systems?

A currency board system is a rule-based monetary regime encompassing two distinct features: full reserve backing requirement of the monetary base, and an explicit commitment of the currency board or monetary authority to convert the domestic currency into a
reserve currency at a prescribed fixed exchange rate. In some countries, such as Argentina and Estonia, the backing rule and convertibility undertaking are specified in laws to demonstrate the government’s commitment to the currency board system.

The backing rule forbids central bank creation of unbacked monetary liabilities through lending to the public or the private sector. The monetary discipline so imposed, together with the explicit commitment to the fixed exchange rate between the domestic currency and the reserve currency, adds credibility to the currency board system, and has led to the perception that it is a particularly robust form of fixed exchange rate system.

3. **Would the stability of the renminbi have implications on the Hong Kong dollar’s link with the US dollar?**

The view that the Hong Kong dollar and renminbi are inextricably linked is not borne out by historical experience or economic reasoning. Since Hong Kong’s adoption of the linked exchange rate in 1983, the renminbi exchange rate has been subject to four major downward adjustments. None of the adjustments had a negative impact on the trade and exchange rate performance of Hong Kong. Taking into account Hong Kong’s role as a major entrepot for Mainland’s exports, a renminbi devaluation might actually boost Hong Kong’s trade performance. Recently, there has been a decoupling of the movement of the Hong Kong dollar forward exchange rate and that of the renminbi non-deliverable forward (NDF) rate. This reflects growing market recognition that the two exchange rates are not inherently linked to one another.
4. **Will the Hong Kong dollar be replaced by the renminbi when the renminbi becomes fully convertible?**

The principle of “one country, two systems, two currencies” is clearly enshrined in the Basic Law. Article 111 stipulates that “The Hong Kong dollar, as the legal tender in the Hong Kong Special Administrative Region, shall continue to circulate.” We do not envisage any change to the legal tender status of the Hong Kong dollar when the renminbi becomes fully convertible.

5. **What would have happened to Hong Kong during the Asian financial crisis of 1997/98 if the Hong Kong dollar had been allowed to float?**

If the Hong Kong dollar had been allowed to float in response to the devaluations of other Asian currencies, this might have triggered a spiral of further currency depreciations in the region. It is hard to predict the repercussions, but the overall consequences could have been adverse for both Hong Kong and the region. In addition, the uncertainty and disturbance caused by a change in the linked exchange rate system would have significantly affected investor confidence in Hong Kong. The fact that the Hong Kong dollar is the only freely convertible currency in the region that withstood the pressures generated by the Asian financial turmoil demonstrates that the linked exchange rate system has been an effective anchor for monetary and financial stability in Hong Kong.
6. **How far does the linked exchange rate system contribute to recession and impede economic recovery?**

There is no reason to believe that the linked exchange rate system is a cause of recession. However, it may intensify economic cycles in the short run, since there is no room for the exercise of independent monetary policy to moderate economic fluctuations. But, while the profile of cyclical adjustment is different between fixed and floating exchange rate regimes, the efficacy of an exchange rate regime should be judged over the longer term. In the case of a floating rate regime, external competitiveness may be quickly restored through currency depreciation. Depreciation, though, may well undermine the credibility of monetary policy and itself exacerbate financial volatility. Furthermore, depreciation may consequently reduce the incentive to search harder than before for efficiency gains within the local economy to ensure stronger economic performance over the longer term. As such, the initial competitive gains may be eroded over time. Under the linked exchange rate, on the other hand, competitiveness can be restored only through internal deflation of costs and productivity gains. The process inevitably takes time. Thus, the discipline of the linked exchange rate gives rise to a search for efficiency gains and structural reforms, which benefits the economy in the longer run.
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