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 the 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.

Joseph Yam
Chief Executive
Hong Kong Monetary Authority
November 2000
A brief history of Hong Kong Dollar Exchange Rate Arrangements

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 1880 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$1.73 to the US dollar, and then, from February 1973, at HK$1.660. 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.2

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.

2 The Hong Kong dollar was then linked briefly to the US dollar, first at the rate of HK$1.73 to the US dollar, and then, from February 1973, at HK$1.660. But, from June 1972, the note-issuing banks were allowed to purchase certificates of indebtedness with Hong Kong dollars.
Why The Link is Important to Hong Kong

Flow of funds into or out of the Hong Kong dollar. Since September 1996, the HKMA has provided a clear understanding 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 Hong Kong dollars in their clearing accounts into US dollars at a fixed rate. 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 in order to replenish their Hong Kong dollar clearing accounts.

Under the currency board system, it is interest rates rather than the exchange rates 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 capital movements. The exchange rate remains stable. This process is very much an automatic mechanism, which does not require the HKMA to exercise any discretion.

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 these 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 1996, the HKMA has provided a clear understanding 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 Hong Kong dollars in their clearing accounts into US dollars at a fixed rate. 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 in order to replenish their Hong Kong dollar clearing accounts.

Under the currency board system, it is interest rates rather than the exchange rates 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 capital movements. The exchange rate remains stable. This process is very much an automatic mechanism, which does not require the HKMA to exercise any discretion.

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 these 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 1996, the HKMA has provided a clear understanding 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 Hong Kong dollars in their clearing accounts into US dollars at a fixed rate. 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 in order to replenish their Hong Kong dollar clearing accounts.

Under the currency board system, it is interest rates rather than the exchange rates 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 capital movements. The exchange rate remains stable. This process is very much an automatic mechanism, which does not require the HKMA to exercise any discretion.

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 these 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 1996, the HKMA has provided a clear understanding 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 Hong Kong dollars in their clearing accounts into US dollars at a fixed rate. 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 in order to replenish their Hong Kong dollar clearing accounts.

Under the currency board system, it is interest rates rather than the exchange rates 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 capital movements. The exchange rate remains stable. This process is very much an automatic mechanism, which does not require the HKMA to exercise any discretion.

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 these 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
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.

How The Link Works

Hong Kong’s Linked Exchange Rate System

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 required 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 realignment 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

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 defeat 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.

Alternatives To The Link?

Hong Kong Economic Indicators

Limitations Imposed By The Linked Exchange Rate System
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, thus 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 subject to overshoot or undershoot to an extent that 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 lending 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
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, the renminbi devaluation might actually boost Hong Kong’s trade performance. Recently, there has been a decoupling of the movement of the Hong Kong dollar’s 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.
Further Reading


Yam, Joseph, A Modern Day Currency Board System. Hong Kong: Hong Kong Monetary Authority, November 1998

Yam, Joseph, Review of Currency Board Arrangements in Hong Kong: Hong Kong Monetary Authority, December 1998

Yam, Joseph, The Hong Kong Dollar Link. Hong Kong: Hong Kong Monetary Authority, March 1998

Hong Kong Monetary Authority Website: www.hkma.gov.hk