

# An Analysis of the Benefits, Dilemmas, and Sustainability of Hong Kong's Linked Exchange Rate System

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**Abstract:** The Hong Kong linked exchange rate system was introduced in 1983 and has been in place for almost 40 years. During these almost 40 years, the system has brought many benefits to the region and helped Hong Kong's financial markets to remain stable during several crises. However, with nowadays changes in the economic environment, national policies, the global economy, as well as the gradual rise in the cost of adopting the linked exchange rate system, many voices have emerged against the continued use of this system. However, after considering the perspectives of government credibility, elastic and alternate choices for the current linked exchange rate system. The paper ended with the conclusion that the linked exchange rate system in Hong Kong should be maintained.

## 1. Introduction

As an international financial center in Asia, Hong Kong is directly connected to world trade and has its own system to ensure exchange rate stability, which is known as the Linked Exchange Rate System. This system was formally developed by the Hong Kong Monetary Authority (HKMA) in 1983 and pegs the Hong Kong dollar (HKD) to the US dollar (USD) at an exchange rate of 7.8:1 [1] with the aim of stabilizing the exchange rate under the circumstances of the disintegration of the Bretton Woods System and the implementation of the floating exchange rate system. Prior to 1972, as a British colony, the Hong Kong dollar was pegged directly to the British pound. However, due to the gradual weakening of the British economy and the implementation of a free-floating system in the United Kingdom, Hong Kong switched to a peg to the US dollar for the next two years from 1972 onwards [2]. In November 1974, the Hong Kong dollar turned to be free-floating again due to the weak US dollar. This brought Hong Kong's economy to a period of turbulence. To rescue the financial system, the Hong Kong government pegged the Hong Kong dollar to the US dollar in 1983, and the system has been in place ever since. Now that this exchange rate system has been established for almost 40 years, the economic environment, national policies, and even the global economy have been involved in a series of changes, thus sparking a heated debate on whether it is time to adjust the exchange rate system. This paper will examine the benefits, dilemmas, and sustainability of the linked exchange rate system and conclude with recommendations for maintaining the current exchange rate system.

## 2. The Mechanism of the Hong Kong Linked Exchanged Rate System

### 2.1 Hong Kong's foreign exchange reserves

Hong Kong's foreign exchange reserves are held by the Hong Kong Exchange Fund. In theory, reserves equivalent to the monetary base would be sufficient (about two times). To avoid potential risks, the reserves needed to safeguard the stability of the Hong Kong dollar are many times higher in practice than in theory.

### 2.2 Automatic regulation mechanism

The linked exchange rate system is a currency board system that has two exchange rates. One is the pegged exchange rate of HK\$7.8 to US\$1, which exists between the HKMA's transactions with

certificates of indebtedness issued by the three note-issuing banks, these three-government authorized note-issuing banks must support the money supply with the equivalent US dollar if they want to increase or decrease the money supply by using the foreign exchange reserve; The other one is the market exchange rate. This automatic adjustment mechanism ensures that the market value of the Hong Kong dollar does not deviate significantly from the linked exchange rate. Under the linked exchange rate system, maintaining the stability of the market exchange rate depends on the arbitrage behavior of the three banknote issuing banks. Whenever the market exchange rate fluctuates and deviates from the linked exchange rate, the three note-issuing banks can make profits by buying or selling certificates of liability from the HKMA at the linked exchange rate. When the HK dollar faces appreciation in the market, the three banks will buy certificates of indebtedness in US dollars from the HKMA and issue HK dollars at a profit. This allows Hong Kong's monetary base to expand, through which the money supply in the market increases, forcing interest rates down and bringing the Hong Kong dollar back to its pegged exchange rate.

### **3. Benefits of the Hong Kong Linked Exchanged Rate System**

The linked exchange rate system has survived several financial crises since its implementation, for instance, the Mexican currency crisis in 1994-1995, SARS and the Asian financial crisis, etc. [3]. During these crises, the Hong Kong government has devoted a considerable high cost to defending this exchange rate system. This triggers the author's curiosity: Why is the linked exchange rate system so important? What are the benefits brought by this system?

1) The linked exchange rate system has stabilized the value and exchange rate of the Hong Kong dollar. From a historical perspective, it can be concluded that this system has realized its aim: stabilizing the HKD value and enhancing the public's confidence. In the early 1980s, before the system was put forward, the HK dollar had depreciated to HK\$9.6: US\$1, falling by 48% year on year [4]. Since the promulgation of the 1983 linked exchange rate system, the Hong Kong dollar has obtained a relatively stable monetary value. The financial market has been rescued as public confidence increased again.

2) The stable exchange rate encouraged foreign trade activities. Hong Kong is an active hub for international trade. If Hong Kong's exchange rate is unstable, it will certainly damage traders' confidence in the market. For example, if the Hong Kong dollar depreciates, exporters to Hong Kong may suffer a loss of profits with no change in the price. Conversely, a stable exchange rate regime can stimulate traders' interest in participating in international trade by reducing the foreign exchange risk in international finance, thereby bringing substantial development to Hong Kong's economy, especially when pegged to the US dollar, the leading international reserve currency, the exchange system could be rather stable [5].

3) The linked exchange rate system can limit the decisions of the Hong Kong government and banks to a certain degree. According to the Hong Kong Monetary Authority, to issue Hong Kong dollars, banks need to have 100% foreign reserves. Under this premise, the banks' financial leverage ratio (for maintaining good solvency) and the government's budget balance (for simultaneously having enough foreign reserve preparation) are somewhat limited [6].

4) The linked exchange rate system has helped Hong Kong to resist certain financial crises and political influences. From historical experience, the linked exchange rate system has already survived several crises from 1983 to 2022, such as the Hong Kong stock market crash in 1987 and the subprime crisis in 2008, indicating that the system has vigorous vitality. A stable monetary value could also stabilize public confidence and social order, and the affluent foreign reserve required by the system can help maintain the financial markets. The article given by Wang also mentioned that if we see from another side, giving up this system could even increase the uncertainty of the exchange rate, and in turn, the market's attractiveness to some investors would decline [7]. To avoid such kind of uncertainty, it is indeed beneficial to the Hong Kong economy to maintain the current system.

#### 4. The Current Dilemmas of Hong Kong Linked Exchange Rate System

Despite the many benefits that the linked exchange rate system brings and the fact that it has been in use for several years, it is important to acknowledge the fact that the world is changing rapidly today. Because of some factors like the fluctuation of the exchange rate and interest rates as well as the change of inflation rates, the financial market especially varies from minute to minute. With the rise of the RMB in recent years, coupled with the change in Sino-US political relations and the influence of the high inflation rate, the call of abolishing the linked exchange rate system from all walks of life has become increasingly strong. Hence, the linked exchange rate system steps into a new dilemma recently. From a historical perspective, during the Asian Financial Crisis (1997-1999), some international speculators noticed Hong Kong's financial market. Considering that there would be an unaffordable cost for the Hong Kong Government to maintain the linked exchange rate system, George Soros began to attack the financial system. The Hong Kong government has successfully defended its exchange rate system finally, but the cost invested is unimaginable [8]. Furthermore, pegged to the US dollars would make the Hong Kong government lose the power to adjust its inflation rate by monetary policies. These illustrate the disadvantages of maintaining the linked exchange rate system: it relies too much on the US dollars; it is rather easy to be attacked and the maintenance cost can be extremely high.

Besides, the recent rise of the RMB is another important factor. China's economy has developed rapidly in recent years after the reformation and opening up, providing RMB an excellent growth potential. With the development of the RMB market in Hong Kong, HKD may be marginalized. Seeing from Figure 1&2, we can find that in recent years, the status of the RMB has improved and the currency value has appreciated generally. Under this condition, pegged to the US dollar may not still be a good choice for Hong Kong.

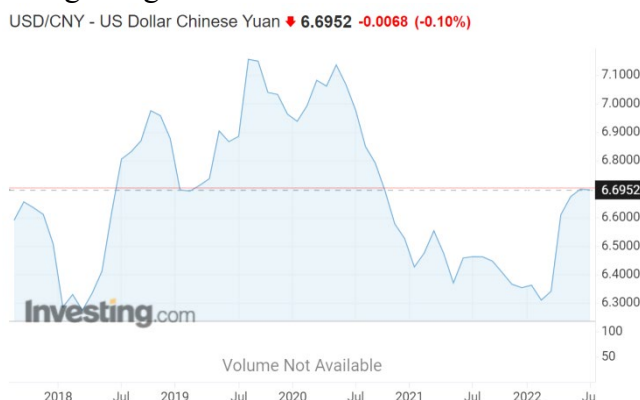


Fig. 1 Changes in USD/CNY Exchange Rate (Investing.com)



Fig. 2 Changes in HKD/CNY Exchange Rate (Investing.com)

The other factor is the Sino-U.S. political game. In June 2020, Hong Kong National Security Act has been passed, after which Donald Trump announced the US-Hong Kong Policy Act stipulated in 1992 has been canceled [9]. In the US-Hong Kong Policy Act, free convertibility between the USD and HKD had been allowed, becoming the base of the Hong Kong linked exchange rate system [10].

Therefore, the cancellation of this Policy Act has raised concerns about whether the system would be canceled as well.

In summary, the Hong Kong linked exchange rate system has dropped into a dilemma recently. Although it has promoted Hong Kong's stable development, many new obstacles occur with the change in the global environment. The future of this system triggers the public's concern.

## **5. The Sustainability of the Current Exchange Rate System**

The debate on whether to reform the linked exchange rate system has been ongoing, especially when Sino-US relations have deteriorated and the RMB has become more internationalized. People are full of doubts about whether the system can smoothly withstand the impact of the financial crisis. Combined with the benefits and dilemma mentioned above, the following contents are analyzed from three perspectives, including government credibility, elastic and alternate choices for the current system, leading to the conclusion that Hong Kong should maintain the current linked exchange rate system pegged to the US dollar.

### **5.1 The importance of government credibility**

According to a report published by the Hong Kong Monetary Authority-Monetary operations under the Currency Board system: the experience of Hong Kong, it considers the credibility of the government as a key factor in maintaining the linked exchange rate system [11]. Over the past 39 years, Hong Kong's overall economy has developed well and the exchange rate system has operated smoothly, successfully withstanding many large-scale economic shocks. The SAR Government has established and maintained a fairly high level of government credibility. Even during the 2008 global financial crisis, the HK SAR Government has repeatedly stated that it will continue to maintain the linked exchange rate system. At the same time, the characteristics of HK's small and highly open export-oriented economy determine the importance of maintaining the government's reputation. As far as the current situation is concerned, Hong Kong will not abandon the current exchange rate system.

### **5.2 The best-pegged currency—the US dollar**

At present, the US dollar remains the most common currency in finance and is considered the best-pegged currency. Hong Kong's economic cycle and financial environment are still largely affected by the US financial environment. Although in May 2020, Trump announced the cancellation of the US-Hong Kong Policy Act, the linked exchange rate system can still exist for a long time regardless of the Sino-US political game. It is difficult for the US to limit the linkage system because international trades happen all the time, this kind of behavior will also cause a great impact on the US economy.

### **5.3 None of the existing reform plans are fully feasible**

#### **5.3.1 Linked exchange rate system pegged to RMB is not very practical**

In 2002, a report by Bank of China International suggested replacing the dollar's peg with the Renminbi, which led to unusual volatility in Hong Kong's currency markets, indicating that there were still doubts about the yuan replacing the dollar in the financial market. Moreover, as an international financial city, Hong Kong has a typical export-oriented economy. The use of Hong Kong dollars to peg the US dollar to stabilize the exchange rate reduces the large number of foreign exchange risks that exist in international trade and economic life. The conclusion and the pooling of international capital have brought more benefits and opportunities to Hong Kong. These can also be said to be the internal causes that led to the creation and continuation of the linked exchange rate system. Some may propose the RMB as a pegged currency, especially since the economic and trade exchanges between Hong Kong and the Mainland have intensified in recent years and the acceptance and circulation of the RMB in Hong Kong have made breakthroughs. However, given the fact that the RMB is not freely convertible, the mainland's financial system is not sound, and the government controls policy, it will take some time to realize the linked exchange rate system with the RMB pegged.

### **5.3.2 Implement a floating exchange rate system is too risky**

On a global scale, Singapore, Luxembourg, Dubai, and other highly open and international city countries or governments similar to Hong Kong did not choose a linked exchange rate system that is fixedly linked to international currencies such as the US dollar or the euro. Instead, they implemented independent currencies and policies system. Compared with Hong Kong, Singapore has not brought serious negative effects due to its independent monetary policy. However, Singapore's successful experience cannot be simply copied. Implementing a floating exchange rate system like Singapore is risky, and the HKMA will face tremendous pressure. The particularity of Hong Kong is mainly reflected in the fact that HK's trading must include a large percentage of RMB, but the RMB is not freely convertible. How to reasonably value the weight of RMB has become a difficult problem. When the Hong Kong government intervenes more heavily in the market, the transparency of exchange rate policies will be affected, and it is more likely to damage Hong Kong's reputation and image as the world's freest economy.

## **6. Conclusions and Recommendations**

No exchange rate system is optimal at anytime and anywhere, and any exchange rate system may play a positive role in the stable growth of the economy. According to the benefits and dilemmas mentioned above, also consider that it is difficult to have a better choice of foreign exchange rate system, keep maintaining the original linked exchange rate system pegged to the US dollar and make some reforms in terms of fluctuation range controls, government policies and foreign exchange reserves issues is undoubtedly a good way.

### **6.1 Relax the fluctuation range of the HK dollar against the US dollar**

To maintain the original linked exchange rate system, HKMA should improve the scope of exchange rate fluctuations and control index and should also increase the autonomy in implementing monetary policy. These kinds of actions can prevent the HKMA from sacrificing monetary policy to adjust the economy to maintain the stability of the fixed price ratio between the HK dollar and the US dollar when the US monetary policy changes. The floating range of the fixed price ratio between Hong Kong and the US can be appropriately adjusted to optimize the linked exchange rate system.

### **6.2 Improve and strengthen the supervision of financial activities**

In terms of financial supervision, since changes in the US monetary policy will increase the spread between Hong Kong and the US, it is easy to cause speculation in Hong Kong. In order to maintain the stable operation of the HK dollar LERS, the HKMA should start with financial supervision and strengthen the flexibility of the system. Faced with the excessive flow of international speculative capital, discovering potential crises in time and formulating countermeasures in advance are very necessary and important.

### **6.3 Pay attention to foreign exchange reserves**

There is no doubt that foreign exchange reserves (US \$) are the operating basis of HK linked exchange rate system. The more the foreign exchange reserves, the stronger the ability HK Monetary Authority has to maintain the local currency exchange rate market. However, foreign exchange reserves are not the fundamental guarantee of this system. There are mainly two reasons, the first one is relevant to the insufficient accumulation ways of foreign exchange reserves in Hong Kong. HK foreign exchange reserves are still mainly derived from capital inflows and reserves acquired through net export trade which are very limited. As the Federal Reserve continues to tighten monetary policy, the monetary base is bound to continue to shrink, which may have a major impact on asset prices and corporate financing. Therefore, although Hong Kong's foreign exchange reserves are at the highest level in history, about 441.3 billion dollars [12], they are vulnerable to the impact of the external environment due to their small accumulation.

Moreover, it is difficult for the HKMA to respond to residents' requests for deposit exchange. According to Article 112 of the Hong Kong Basic Law, "The Hong Kong Special Administrative

Region does not implement foreign exchange control policies.” The Hong Kong dollar is freely convertible. According to statistics published on 31 May, 2022 by the Hong Kong Monetary Authority, Hong Kong dollar deposits decreased by 0.5% among the total, while foreign currency deposits remained virtually unchanged. Changes in deposits are affected by a wide range of factors, such as interest rate movements and fund-raising activities. However, once residents’ confidence is shaken and they scramble to convert their domestic currency into foreign currencies, a large number of foreign exchange reserves may be exhausted. At that point, the linked exchange rate system would also be at risk. Therefore, relevant management agencies cannot relax their vigilance just because the foreign exchange reserves are sufficient.

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