Article:

Why Hong Kong’s Currency Is Still Rock Solid

Hong Kong’s currency-board arrangement has served it well and isn’t going anywhere

When the future of Hong Kong was hanging in the balance during Sino-British handover talks, the city’s currency lost around a third of its value against the dollar in just 12 months. The Hong Kong government then decided in 1983 to peg its currency to the dollar to restore confidence. The exchange-rate system put in place then should once again weather the turmoil the city is facing.

Could the protests that have embroiled Hong Kong for more than 100 days bring down the 36-year peg? The worries are understandable: Fixed-exchange-rate regimes fail all the time.

But Hong Kong’s currency-board system is far more robust than an ordinary peg. Every single Hong Kong dollar in circulation is fully backed by liquid dollar-denominated foreign reserves. In fact, Hong Kong’s $433 billion of foreign reserves is more than twice its monetary base, which also includes excess reserves in the banking system and short-term bills issued by the city’s de facto central bank.

Last in a Series

Even before protests shook Hong Kong this summer, there was widespread fatalism about its future as a financial and trade center. But Beijing’s dependence on the “special administrative region” runs far deeper than it might appear. This series has taken an in-depth look at the economic stakes for China and Hong Kong in the current upheaval.

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Unlike many governments with failed pegs, Hong Kong has been very disciplined in sticking to its rules: It cannot create unbacked money, and has to allow its monetary base to fluctuate with capital flows. Hong Kong’s money-supply growth has largely been in line with the growth of its foreign reserves.

Even against a broader measure of money supply, Hong Kong’s reserves still look ample: Reserves stand at nearly half of Hong Kong’s local-currency M3, which includes all the Hong Kong dollar deposits in the city. It would take an unprecedented exodus of capital to push the reserves to dangerous levels.

The drawback of the peg is that it can create booms and busts in local asset prices as Hong Kong has essentially handed over its monetary policy-making to the Federal Reserve. The city's famously expensive property market is at least partly attributable to the currency arrangement, as local authorities can't tighten monetary policy on their own to rein in asset bubbles.

On the other hand, when capital flows out of Hong Kong the currency-board arrangement means interest rates should automatically rise, which may in turn drive property or stock prices much lower. This was the cost of defending the peg during the Asian financial crisis of 1997-1998.

But these costs must be weighed against the benefits. Having such a dependably stable currency has vastly helped Hong Kong in its role as an intermediary between China and the rest of the world, first as a trading port and more recently as a financial center. Abandoning the peg now, just as other questions swirl over the city's future, would put all this at risk. That is why it won't happen for the foreseeable future.

By Jacky Wong
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Commentary

The above article illustrates the potential danger to the Hong Kong-US dollar fixed exchange rate system, by Hong Kong's central bank, due to social unrest within the citizens of Hong Kong. The current exchange rate, $7.85 HKD to $1 USD, has been speculated to show fluctuations.

The HK central bank holds abundant foreign reserves that enable the city to control the value of its currency in situations, where fluctuations in exchange rate with USD are probable. A comparison is drawn between the size of the monetary base, which includes the excess reserves of HKD in both the commercial and central bank and the HKD in circulation in the domestic economy, and the foreign reserve, which includes the reserves of the USD and other currencies in the central bank of Hong Kong, wherein, the latter proved to be much larger, because the central bank intends to use the foreign reserve to control the exchange rate with the USD.

The money supply in Hong Kong is prone to fluctuation due to capital transactions, such as direct investments by Hong Kong citizens in foreign assets. However, even though this transfer reduces the HKD money supply, the central bank does not permit the excess reserves with the commercial banks to increase, which can in turn increase HKD money supply in the economy. The higher HKD money supply will conflict with the objective of managing the exchange rate with the USD by devaluing the HKD. Therefore, the money supply has a proportional relationship with the foreign reserves in HK as only when the foreign reserves increase, will the central bank allow excess reserves to be increased to increase the money supply of HKD so that the fixed exchange system remains unaffected by HKD's money supply.

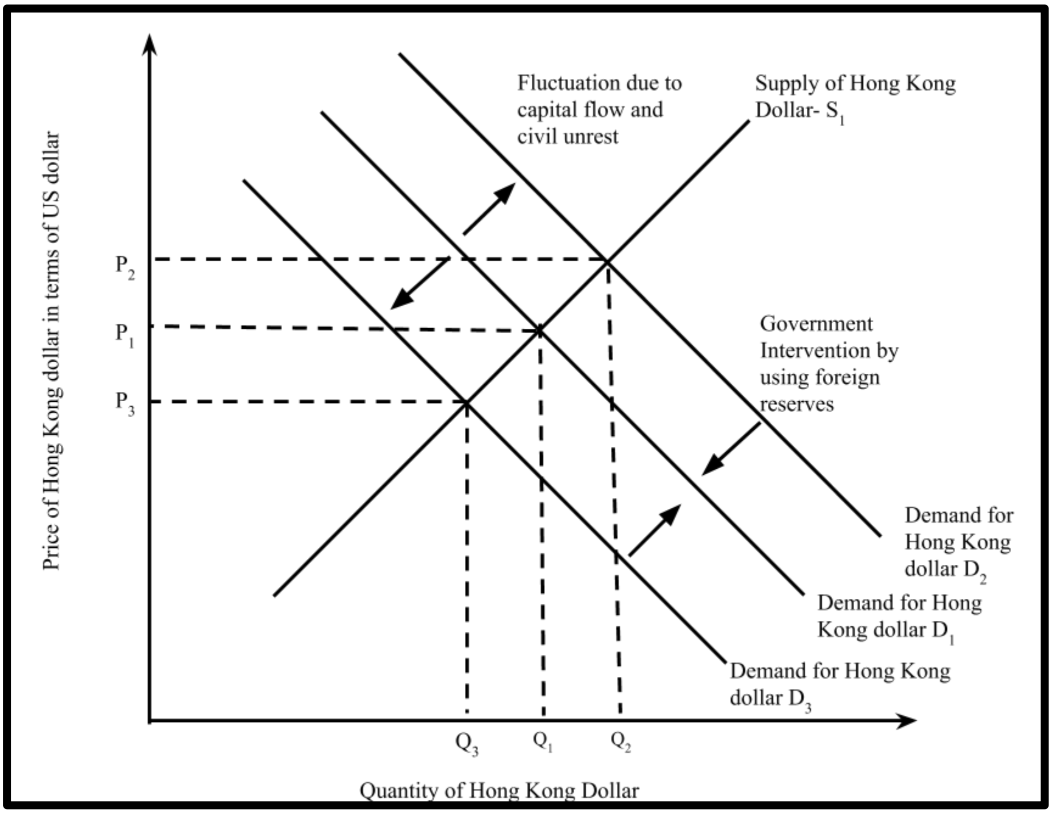

Figure 1: Pegged Exchange rate of HKD with the USD

Figure 1 depicts the fixed exchange system of HKD with the USD, wherein, the exchange rate is pegged at price P_1. The shift of the demand curve from D_1 to D_3, due to the loss in confidence in the currency because of the civil unrest, leads to the HKD being devalued by falling to P_3 from P_1, and the quantity demanded falling from Q_1 to Q_3. The central bank intervenes in the foreign market by using the USD from the foreign reserves to increase demand for the HKD. This causes the demand curve to shift back to D_1 from D_3 and restores the HK central bank's fixed exchange rate, P_1.

In a case where direct investments in Hong Kong by American citizens are increased, demand curve shifts from D_1 to D_2. This leads to the revaluation of the currency as P_1 increases to P_2 and quantity of HKD demanded increases from Q_1 to Q_2. Since this leads to the exchange rate to reach the extreme of the range, the central bank intervenes by buying USD to add to their foreign reserve by spending their reserves of HKD to devalue the HKD against USD. This again restores the demand curve from D_2 to D_1 and the fixed exchange rate, P_1, is maintained. Following this, the central bank will allow the banks to increase their excess reserves to boost money supply.

By fixing the HKD-USD exchange rate, the HK government manages to prevent speculation in the exchange rate. This facilitates trade flows between Hong Kong and the US and prevents fluctuations in exchange rates, due to changes in confidence of speculators. Exporters in HK can expand their output since the exchange rate maintains stability. This will also attract foreign direct investors due to the sustained stability.

However, fixing the exchange rate negatively impacts the HK economy. The target of fixing the exchange rate interferes with other domestic policy measures such as price stability. The central bank controls the interest rate in HK, however, it will not implement contractionary fiscal policy even though asset prices in HK are inflating, because such a policy attracts foreign financial investment and revalues the HKD. The constraints on the policies also reduces the ability of HK to deal with external supply shocks. On top of that, holding high official reserves by the central bank to maintain market confidence and lead to the opportunity cost of not spending the money for welfare, debt, and capital growth.

In order to change policies to achieve macroeconomic goals in HK, the government must consider whether the policy assists in setting the value of fixed the exchange rate or if the exchange rate remains unaffected. Only then will the policies be implemented.

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