The linked exchange rate system between us $ and hong kong $

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 1. Introduction 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 important the Link is to Hong Kong’s economy, as well as the limitations that a monetary system of this kind imposes on policy making. 2. A brief history of Hong Kong dollar exchange rate arrangements 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. 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. TheHong 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. EXCHANGE RATE REGIMES FOR THE HONG KONG DOLLAR Date Exchange rate regime Reference rate 1863 – 4 November 1935 Silver Standard Silver dollars as legal tender

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_ December 1935 Link to Sterling ? = HK$16 (December 1935 – November 1967) Link to Sterling ? 1 = HK$14. 55 (November 1967 – June 1972)

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6 July 1972 Link to the US dollar with US$1 = HK$5. 5 ± 2. 25% intervention (July 1972 –February1973) bands around a central rate Link to the US dollar US$1 = HK$5. 085 (14 February 1973 – November 1974)

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25 November 1974 Free float Exchange rates on selected dates US$1 = HK$4. 65 (25 November 1974) US$1 = HK$9. 600 (24 September 1983)

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October 1983 Link to the US dollar US$1 = HK$7. 80

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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 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% injust 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 one US dollar. 3. 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 the external trade in goods and services in a year is equivalent to well over three times to GDP. These factors leaves Hong Kong 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 Hong Kong 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 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, the Hong Kong Government pursues a prudent fiscal olicy, 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$122. 8 billion at the end of September 2005. They are equivalent to over six times the currency in circulation – one of the highest levels in the world. 4. Limitations imposed by the 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 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 since 1983. 5. Alternatives to the Link?

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? 5. 1 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. 5. 2 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 Hong Kong trade and external financial transactions are denominated. 5. 3 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. 5. 4 Free float of the Hong Kong dollar? Under a free floating exchange rate regime, the monetary authority would have