

## **Lecture 2. The Stability and the Future of the Exchange Rate System in Hong Kong**

### 1. Two Major Crises for the LERS

#### (1) The 1997 Asian Financial Crisis

##### a. Deficiencies associated with the pre-AFC LERS

- Lack of effective currency arbitrage mechanism and the HKMA has to use liquidity adjustment or interest rate intervention policies to defend the link
- The Liquidity Adjustment Facility (LAF) operated by the HKMA did not allow the banks to borrow substantially from the HKMA and hence the monetary base of Hong Kong is too narrow and easy to hit the liquidity constraint

##### Problems:

Under a speculative attack on HK dollar on 23 October 1997, the overnight interbank rate shot up to as high as 280%. The high rate hurt the real economy and plunge the stock market.

<http://www.cepii.fr/anglaisgraph/publications/lettre/pdf/2000/186ang.pdf>

##### b. Reforms of LERS after AFC

1998: seven technical measures which can be summarized as the following two:

- providing a clear undertaking to all licensed banks in Hong Kong to convert Hong Kong dollars in their clearing accounts into US dollars at the fixed exchange rate of HK\$7.75 to US\$1 with HKMA (weak-side convertibility).
- replacing Liquidity Adjustment Facility by a Discount Window

[http://www.info.gov.hk/hkma/eng/press/1998/980905e\\_index.htm](http://www.info.gov.hk/hkma/eng/press/1998/980905e_index.htm)

1999:

The movement of the exchange rate under the Convertibility Undertaking in respect of the Aggregate Balance from 7.7500 to 7.8000 by 1 pip per calendar day (as announced on 26 November 1998).

[http://www.info.gov.hk/hkma/eng/press/1999/990331e4\\_index.htm](http://www.info.gov.hk/hkma/eng/press/1999/990331e4_index.htm)

With these reforms, Hong Kong's monetary base has been enlarged and it is difficult for speculator to attack HK dollars. It also greatly facilitates the currency arbitrage and enhances the automatic adjustment mechanism of the link.

## (2). Renminbi Appreciation in 2005

Since 2003, Hong Kong experienced a huge inflow of capital due to the strong recovery of its economy, relative weak US dollar and speculation on the revaluation of Renminbi. The situation had reached its peak in 2005 after the Chinese currency was forced to float with the US dollar. The huge inflow of capital pushed interbank interest rate in Hong Kong to almost 0% and seriously and made the interest adjustment mechanism under the LERS ineffective.

2005: three refinement measures:

- establish a strong-side Convertibility Undertaking (CU) at HK\$7.75/US\$
- shift the weak-side CU from HK\$7.80/US\$ to HK\$7.85/US\$
- create a Convertibility Zone defined by CUs, within which the HKMA may conduct market operations consistent with Currency Board principles

## 2. Challenges facing the LERS

### (1) The further revaluation of Renminbi

- The economies of Hong Kong and the mainland are

highly integrated now. Given the further appreciation of Renminbi, Hong Kong dollar will under serious pressure to appreciate as well. Hong Kong relies on the mainland for its major food and household consumption goods supply, the further appreciation of Renminbi will bring huge inflation pressure on Hong Kong. At the same time, it will also trigger asset prices in Hong Kong to rise as well and cause potential asset bubble in Hong Kong.

- Hong Kong economy is becoming more dependent on the Chinese economy and less on the US economy. There is an increasing tendency for the business cycle of Hong Kong to diverge from that of the US. This will seriously undermine the stability of the Hong Kong economy.

### 3. Any alternatives to the LERS?

- Free float of the HK dollar: lack of credibility?
- Link to a basket of currencies: no transparency?
- Change the current rate link to the US dollar: loss of credibility?
- Link to Renminbi: Renminbi is not fully convertible and political consideration.

Readings:

<http://www.imf.org/external/np/speeches/2001/010601a.pdf>

<http://www.hkbu.edu.hk/~sktsang/seminar.html>

Yam, Joseph (Jan. 1999), "Causes of and Solutions to the Recent Financial Turmoil in the Asian Region." <http://www.info.gov.hk/hkma/eng/speeches/index.htm>

[http://mpra.ub.uni-muenchen.de/9440/1/MPRA\\_paper\\_9440.pdf](http://mpra.ub.uni-muenchen.de/9440/1/MPRA_paper_9440.pdf)