

## A LINKED EXCHANGE RATE AND A SMOOTH TRANSITION\*

*As a small open economy, exchange rate stability is the best choice as Hong Kong's monetary policy goal. The linked exchange rate has stabilised the financial markets and the economy. It is well accepted and understood by people from all walks of life and has shown itself resilient to shocks. The link should be maintained through the transitional period in 1997 and beyond.*

### Introduction

The linked exchange rate system in Hong Kong has prevailed for eleven years. It is well known that the system has evolved along with the Sino-British negotiations on the issue of sovereignty over Hong Kong.

The linked exchange rate system was originated for a one-time need to contain the sharp depreciation of the HK dollar in 1983. It evolved under a unique political and historical circumstance. From its inception, the system has been integrated with the transition process of Hong Kong's sovereignty. These features of the system carry implicit arguments to a different extent for both its supporters and opponents.

Given the system's accidental nature, people have often been wary of its sustainability. When economic conditions deteriorated, in particular when inflation rose, the linked system repeatedly became a target for blame. Yet thanks to its political perspective, it has convincingly weathered political incidents and other adverse exogenous forces, and this has been used by its advocates as their chief argument to promote the system.

From the standpoint of the central bank, there are profound economic fundamentals underlying these non-economic features, which justify the inevitability of the inception and continuity of the linked system. In other words, the vitality of the linked system confirms that it has already adapted itself to the prevailing political, economic, and social environments of Hong Kong. It is, therefore, a right choice. I would like now to make some remarks in this regard.

### The sole monetary objective in Hong Kong

As you all know, in different economies, the monetary authorities have different policy objectives. In such larger economies as the United States and Germany, the macroeconomic objectives for the country are usually sustained economic growth, full employment, and low inflation. In these countries, interest rates and money supply are normally used as instruments of monetary policy, and the exchange rate only serves as a measure of the external value of domestic currency and as a means for export stimulation.

Nevertheless, following the increased integration of the global economy and world financial markets, economies world-wide have become more interdependent, and no country today can pursue a completely independent monetary policy. When bilateral or multilateral trade relations become tense, the focus of monetary policy can be shifted tentatively to the impacts of exchange rates. Evidence of this phenomenon is the fact that exchange rate issues have always been among the main items on the agenda of the G-7 finance ministers' meetings of recent years.

Yet, Hong Kong, as a small island city, has the typical properties of a small open economy, which are characterised mainly by a lack of natural resources, heavy reliance on imports of most raw materials and daily necessities, and a large share of foreign investment in the economy. Restrained by these properties, it is unrealistic for a small economy like Hong Kong to count on its domestic economic indicators as policy targets. In Hong Kong, external trade is 2.4 times the size of its GDP, bank deposits in foreign currencies amount

\* This is a translation of a speech given by Chen Yuan, Deputy Governor of the People's Bank of China, to a seminar on "The Impact of the Link" on 28 October 1994.

to about 50% of the overall bank deposits, and one third of the trading volume in the stock exchanges of Hong Kong involves foreign capital. With external factors playing a role to such a dominant extent, the economic growth is apparently subject to factors beyond the control of the domestic authorities. For the same reasons, it is difficult for the monetary authorities to exercise control over the monetary implications of incremental changes of foreign investment or external trade, and it is hence impractical to use interest rates or money supply as targets for monetary policy.

To take advantage of an externally-oriented economy and ease the effect of the external shocks, exchange rate stability in turn becomes the only choice for the small open economy to use as its monetary target. Experience has proved that, as long as the exchange rate stability of the local currency against one specific foreign currency is chosen as the monetary target, this target then tends to demonstrate its exclusiveness. In other words, the monetary authorities cannot consider any targets other than exchange rate stability. Otherwise, exchange rate stability cannot be realised. This phenomenon has already been evidenced in May 1991 when the financial authorities in Hong Kong failed to contain the inflation rate by raising interest rates.

### Conditions for the continuing success of the linked rate

Although the linked exchange rate system was unplanned in its inception, history has confirmed its importance in the stabilisation of the economy and the financial markets. In recent years, Hong Kong has experienced many such exogenous shocks as the global stock market crash of 1987, the Gulf War, the BCCI incident in 1991, and the ERM crisis of 1992. When financial markets frequently responded to these events with sharp falls in stock prices and runs on banks, the linked system demonstrated its vitality in weathering the crisis, and the fluctuation of market rates never exceeded 1% in either direction. I still remember that participants at the seminar hosted by the HKMA in October 1993 confirmed unanimously the role of the linked system in stabilising the exchange rate and concluded that it was a successful system.

Looking at the evolution of the exchange rate system in retrospect, one has to admit that the linked system is a successful innovation. It maximises the stabilisation of the exchange rates - a financial indicator with the most sensitive and least constant nature - to a specific level, and thus well adapts itself to the needs of economic development in those small market economies in which the markets are completely open but vulnerable to both internal and external shocks. In recent years, a similar system has already been adopted by other countries like Argentina. This indicates that its practicality has been further recognised by the international financial community.

Of course, the successful past of the linked system cannot guarantee its future success. But it is our belief that those underlying factors in favour of its effective functioning still remain, and these factors should be the main premise for our evaluation of the system. Let us first look at some **external factors**.

First, as the size of the economy is small, there has never been, and will not be, any need for Hong Kong to maintain the external competitiveness of the local products by adjusting exchange rates. Second, the US dollar is the primary currency of settlement for Hong Kong's external trade. Although the value of the US dollar fluctuates, it is underpinned by the domestic economy of the US. This is unlike the UK economy of the 1960s which relied almost entirely on external markets. It can thus be anticipated that the role of the US dollar as the major international currency will prevail in the foreseeable future. Thirdly, the US dollar will remain as the primary currency for external trade settlements in Hong Kong for quite a long time in the future. Even after the Renminbi becomes convertible, it will not be able to substitute in a short period of time the role of the US dollar in trade settlement. This fact lays the foundation for the continuation of the linked system.

As for **the linked system itself**, it has stronger operational quality in comparison to other exchange regimes. That is, it is easier to operate and thus easier to achieve the monetary policy objectives for exchange rate stability. More specifically, first, when the HK dollar is pegged to the US dollar at a fixed rate, there is no need for the authorities to adjust the exchange rate in order

to maintain the value of the HK dollar; and second, there are no upper and lower limits specified for the market rate movements in the linked system, and this helps contain speculative activities in the market place and gives the Monetary Authority enough flexibility in its efforts to stabilise exchange rates.

With regard to **the main components of the operational mechanism of the linked system**, the first is the establishment of the HKMA which provides an institutional safeguard for the continuation of the linked system. This is because the monetary system in Hong Kong is still somewhat different from the commonly known system of the currency board, and the intervention of the HKMA thus plays an important role in assuring exchange rate stability. From a legal perspective, the HKMA has the irreplaceable responsibility in stabilising the exchange rates, which provides a legal guarantee for improving financial management and securing financial stability in Hong Kong. The second component is the capital strength of close to US\$45 billion in the Exchange Fund which provides a guarantee for the HKMA to be able to intervene in the market and to bolster market confidence. The third is the availability of such numerous financial instruments as the Exchange Fund Bills and Notes and the Liquidity Adjustment Facility, which have been developed in recent years by the HKMA. Moreover, the HKMA has established its own open market operation and the discount window. All of these further strengthen its ability to intervene in the market. The responsibility and position of HKMA will remain unchanged even after 1997, and the PBoC will continue to maintain and strengthen the cooperative relationship with HKMA.

Another major supportive factor to the linked system comes from the adaptability and familiarity of the general public to such a system. The merits of the linked system are reflected not only by its role in stabilising the exchange rates, but also by its simplicity. Because it does not involve complicated exchange rate calculations as normally applied to a pegged currency basket system, it has, on the contrary, provided a method of calculation with high transparency, which can be understood and used by people from all walks of life. In the area of external trade and investment, it has been proved to be a clearer and more sensible method of cost

accounting, and for the general public, it has become an easier measurement of their own wealth. As a result, it has been well accepted and received by both the general public and the markets.

All of the above factors have contributed positively to the sustaining of the linked system. We believe that the linked system will continue its role in achieving monetary policy objectives in Hong Kong in the transitional period up to 1997 and beyond.

### **The linked rate and market confidence**

The Joint Declaration and the Basic Law have already laid the foundation for a smooth transfer of sovereignty of Hong Kong. However, as Hong Kong is an international trade and financial centre, the sustaining of a stable exchange system also has an inestimable importance in the realisation of the smooth transition.

It is clear to all of us here that the essence of the financial issues lies with their sensitivity. In a case where confidence tends to be lacking, it will be extremely difficult to deal with a potential crisis no matter how perfect the monetary system may be. This phenomenon is more prominent in the case of Hong Kong which is a free and externally-oriented small economy. Whenever a sign of turbulence surfaces, it may cause anxiety and panic. In this context, the essence of the linked system is to deflect currency risks, because the linked system has established a pegged relationship of the HK dollar with the US dollar, and thus basically resolved the problem of a lack of confidence in the currency. During a number of past sharp falls in stock prices, there was little pressure on exchange rates. This indicates that the public have confidence in the linked system, and therefore have no need to hedge a large quantity of cash by buying US dollars. Now the issue is how to sustain the confidence of the public in the linked system, because it would again lead to a confidence crisis were the markets induced to suspect the continuation of the linked system.

Although we have listed many of the merits of the linked system, it is admittedly fair to say that there is no perfect exchange rate arrangement. As mentioned earlier, the linked system prevents the monetary authorities from dealing with other

policy targets, for instance, they cannot simultaneously use interest rates as an instrument to contain inflation. However, it is necessary to make it clear that inflation is not a by-product of the linked system. It is only a periodic phenomenon when business cycles in Hong Kong and the United States are not synchronised and the phenomenon of the structural change of the Hong Kong economy. Along with the economic recovery and the rebound in interest rates in the US, the inflationary pressure in Hong Kong will gradually be alleviated. More importantly, inflation can also be contained through the use of many other instruments such as fiscal policy, mortgage credit, labour policy, and the land policy. We always believe that the price to be paid for maintaining the linked system is far less than that for replacing it. It

would apparently be unwise to replace the linked system only for the sake of dealing with periodic inflationary pressure.

All in all, we should make every effort to maintain complete confidence of the markets in the linked exchange rate system. We do not want to hear or witness anything new that would undermine market confidence. We have noted that the officials of the Hong Kong Government of different levels have expressed repeatedly on many occasions that the linked system will remain unchanged. It is our sincere hope that they will honour their commitment in order to ensure the confidence in the HK dollar, and thus contribute in this context to a smooth transfer of sovereignty over Hong Kong. ☉