

HONG KONG'S CURRENCY BOARD ARRANGEMENTS

Currency boards involve the issue of currency against the full backing of a foreign currency. They provide a strong financial discipline but until recently most currency boards had been replaced over time by central banks operating more flexible exchange rate regimes. In Hong Kong foreign reserves more than cover the entire monetary base. Notwithstanding the HKMA's capacity to undertake money market operations, the Hong Kong system remains a currency board.

Currency boards are an institutional arrangement to issue currency (notes and coins) against the full backing of a foreign currency in order to maintain the external value of the domestic currency. They were common in British colonial history, the first currency board being established in Mauritius in the 1840s. By issuing domestic currency at a fixed rate of exchange, usually 100% against sterling, the currency board mechanism imposed strict monetary discipline on an economy, while enabling it to enjoy the seigniorage that would have accrued to Britain had the economy used sterling as domestic currency. At the same time, since the board would not (and could not by law) lend to the government, it imposed strict fiscal discipline on the colonial government.

More so than a "pegged" exchange rate regime, a currency board with 100% reserve backing allows a very credible and permanent form of fixed exchange rate regime. Under a fixed exchange rate, when the economy runs a balance of payments surplus, the inflow of funds into the domestic currency creates higher domestic liquidity, which leads to greater lending and investment, stimulating growth and also potentially inflation. Higher prices at a fixed exchange rate reduce competitiveness, reduce exports and encourage imports until the balance of payments surplus erodes. The outflow of funds associated with this erosion reduces liquidity in the economy, raising interest rates and slowing growth until the balance of payments is restored to equilibrium at the fixed exchange rate level.

While the currency board mechanism was generally successful in maintaining currency stability and financial discipline in the colonial era, and

helped to build substantial foreign exchange reserves in the colonies, it came under attack in the post-colonial period. In part this reflected an assertion of national identity or a desire to have an institution that could act as lender of last resort. It also reflected concerns that the automaticity of the mechanism meant that the economy was subject to sharp cyclical swings, as the fixed exchange rate regime, together with full fiscal discipline, transmitted external shocks quickly to the domestic economy. With fixed exchange rates, there was greater volatility in interest rates and monetary growth, which was also a source of instability for the banking system. Development economists began to feel that discretionary monetary management may help alleviate the pain arising from such sharp swings. Based on this view, it was considered that "a central bank with discretion was bound to outperform a rule-bound currency board."¹

With the increasing popularity of discretionary monetary management came flexible exchange rates. Exchange controls were dismantled, leading to the advent of active foreign exchange markets. As a medium of transaction, in particular large value transactions, notes and coins have also given way to electronic means of payment. This encouraged the development of a money market or interbank market for the domestic currency and a clearing house to enable the large volume of transactions to be cleared and settled. The environment within which currency board systems (and indeed any other exchange rate system) were to function had therefore changed dramatically compared with the colonial era.

But the full convertibility under a currency board system of currency notes and coins against foreign currency, made possible through the 100%

¹ As Schwartz (1992) characterised the prevailing view.

reserve backing, continued to be an effective monetary discipline; and where the backing was at a fixed exchange rate, the arrangement provided an effective anchor for the exchange rate. However, this convertibility was limited only to notes and coins, and did not extend to bank deposits and other local currency denominated assets. So, in the present day monetary environment, one modern version of a currency board system extended this convertibility to what is commonly called reserve balances, defining these to be the money held by banks with the clearing house, which would also be run by the currency board, to facilitate interbank transactions and the clearing of cheques. In other words, the whole of the monetary base, defined to be notes and coins, and reserve balances, is backed 100% by foreign currency held by the currency board. With the currency board buying and selling foreign currency at the fixed exchange rate, there would be a corresponding creation and contraction respectively of reserve balances and hence the monetary base. The currency board could do so entirely passively or with a degree of flexibility, having regard to whether it would want to try and dampen short term volatility in financial markets. Where there was flexibility, it was obviously important not to allow discretion to undermine the monetary rule.

Hong Kong's Currency Board Regime

There are currently a number of economies operating currency boards, including Hong Kong, Singapore, Argentina, Estonia and Brunei. They also operate a fixed exchange rate regime, except Singapore, where the Singapore dollar is pegged against an undisclosed basket of currencies. Hong Kong's currency board regime is unique in the sense that three note-issuing banks issue the currency, against non-interest bearing Certificates of Indebtedness issued by the Exchange Fund at the linked rate of HK\$7.80 to US\$1.

Since 1988, when the Accounting Arrangements were put into place, the Exchange Fund has brought reserve balances of the banking system onto its books. With foreign currency reserves over four times the size of currency in circulation and the balance of the banking system, the foreign currency backing is effectively extended to the whole of the monetary base. Whilst the determination of the size of the reserve balance is

not entirely automatic, the HKMA does ensure that it is fully backed by foreign currency held in the Exchange Fund and that it largely varies in accordance with the underlying flow of funds into and out of the currency.

There is some misunderstanding about whether Hong Kong does or does not run a currency board regime after 1988, given that the HKMA has acquired control over reserve balances of the banking system and therefore has the capacity to conduct money market operations. Some writers consider money market operations an erosion of rule-based behaviour. They have overlooked the fact that the monetary base is more than fully backed by foreign currency reserves. Furthermore, the Exchange Fund does not lend to either the government or to businesses, a classic criterion of currency boards. To the extent that all HK dollar loans to banks are secured against collateral, such as Exchange Fund Bills and Notes that are 100% covered by US dollars, or are foreign exchange swaps or Repos, the Exchange Fund has adhered strictly to the 100% reserve requirement. Increases in the reserve balance are matched largely by increases in US dollar assets in the Exchange Fund.

As long as the 100% foreign exchange reserve requirement for all currency, notes and Exchange Fund monetary base liabilities is adhered to, it does not deviate from the currency board principles. The performance of money market operations over passive accumulation or depletion of foreign currency assets when underlying flows in the external account are normal does not conflict with the objective and the mechanics of the currency board regime. The operations enable short term volatility in financial markets under a totally passive arrangement to be smoothed out. These are monetary measures that strengthen the fixed rate convertibility rule in the longer term rather than weaken such rule-based behaviour. In the words of Bennett (1992):

Currency boards trim a significant number of degrees of freedom from the policy maker's range of options. They also require a stricter and less forgiving attitude towards bank failure, wage and price rigidities and other disturbances...it is these constraints that give currency boards their robustness..”

With strict currency convertibility, a fixed exchange rate, continued budgetary surpluses, strong financial discipline through bank supervisory powers, and a flexible economy that adjusts to the exchange rate, Hong Kong maintains a strong form currency board mechanism that is much more in tune with the rapid changing financial environment of today than the currency board form envisaged in 1935, when the Exchange Fund was first established. *

References

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