

OF PEGS AND BOARDS*

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The Hong Kong dollar has remained stable amidst the recent turmoil in the Asian currency markets. This can be attributed to the built-in, self-stabilising mechanisms under Hong Kong's currency board arrangement. As long as Hong Kong continues to retain the present Linked Exchange Rate System, maintain strong foreign exchange and fiscal reserves, pursue prudent macroeconomic policies, and keep a watchful eye on the banking sector, the Hong Kong dollar will be virtually impregnable.

Why has Hong Kong's peg proved impregnable in the midst of the worst currency turmoil since the Mexican crisis of early 1995? An obvious answer is Hong Kong's exceptionally strong foreign exchange reserves. With US\$81 billion in its kitty, Hong Kong's foreign reserves now rank fifth in the world, and as high as second on a per capita basis, now valued at about US\$12,800¹. Moreover, China, with its reserves of US\$126 billion, has repeatedly vowed that it will stand behind Hong Kong in the event of a currency crunch.

Skeptics in our midst still discount this mighty war chest, and repeat the old refrain that no fixed exchange regime can survive for long against sustained speculative attack. As evidence, they invariably cite the European currency turmoils in 1992-93, the Mexican peso crisis in 1994-95, and the current troubles in Asia as only the most vivid recent examples.

What they miss, however, is that this argument is only valid for conventional, non-currency board types of fixed exchange rate regimes. For a currency board system with fiscal discipline, such as Hong Kong's, this warning falls flat.

Briefly, the currency board system was the monetary stratagem that prevailed in British colonies and protectorates for a century from about 1850. Its salient features are: legal tender currency is not issued by a central bank, but by an independent currency board; such domestic currency must be fully backed, in advance, by an international reserve currency with which the domestic currency is mutually convertible without limit and at a

predetermined exchange rate; the currency board itself does not undertake any banking functions, whether central or commercial.

Because the pound sterling was the international currency chosen as the anchor, this system used to be known as the sterling exchange standard. Hong Kong itself was on this standard between 1935 and 1972, except during the 1941-1945 Japanese occupation. Between 1950 and 1980, the currency board system fell into disrepute, due to anti-colonial sentiments and the influence of Keynesian economics. However, since the mid-1980s, the currency board appears to have enjoyed an intellectual revival.

Hong Kong's successful return to the fold in October 1983 provided the initial impetus. It has now been widely realised that the currency board is a rules-based system that effectively deprives the government of the means to debase the currency. It has also dawned on many countries that there is nothing inherently "colonial" about the system. A small country can freely choose the currency of a country which is not its sovereign as its anchor. Thus, since 1991, Argentina, Estonia and Lithuania have successively adopted some sort of currency board arrangement, with the US dollar or the German mark as the anchor.

Hong Kong's existing linked exchange rate (a better term would be the "dollar exchange standard") is actually a variant of the currency board system, because the local currency is issued by three commercial banks and not by a formal currency board. The 100% foreign exchange rule

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1 As at end-September 1997, the official foreign exchange reserves of Hong Kong, including those held in the Land Fund, were US\$88.1 billion, the third largest in the world.

also is de facto, rather than de jure. Nevertheless, the essence of the currency board is fully preserved. Indeed, Hong Kong's present foreign-exchange holdings cover more than six times its total currency in circulation.¹

Under Hong Kong's present exchange standard, there are two built-in, self-stabilising mechanisms that work more or less the same way as the gold standard, with the US dollar replacing gold. One is the specie-flow mechanism, also known as the Cantillon-Hume mechanism, named after the two economists who first discovered it.

It works this way: suppose that there is a big loss in foreign exchange after a massive attack or an outflow of capital. Then the note-issuing banks, being short of foreign exchange, mostly US dollars, not only cannot issue more notes, but may even be forced to return their Certificates of Indebtedness to the Exchange Fund to redeem their US dollars. This must cause the monetary base to shrink, and given a stable relationship between the monetary base and the money supply, the latter will shrink eventually. The contraction in money supply, in turn, will naturally push up interest rates and deflate the price level. Both effects will tend to stabilise the exchange rate. Note that this mechanism is automatic and permanent, and independent of any overt act of intervention that may be taken by the authorities.

Another mechanism is "arbitrage and competition" which works more or less like the old "gold points". Under the old gold standard, the exchange rate could not fluctuate too much because economic agents would have shipped gold abroad to settle external accounts, instead of using foreign currency. In Hong Kong's case, the Hong Kong dollar's market rate cannot deviate from the official rate of 7.8 by more than the transactions costs without inducing the note-issuing banks to engage in profit-seeking arbitrage with the Exchange Fund. For example, suppose that the market exchange rate rises to 7.9. Then all the note-issuing banks would surrender their Certificates of Indebtedness to the Exchange Fund and redeem their US dollars at 7.8 and would resell them at 7.9, which would make for the convergence of the market rate towards the official rate.

Note that this mechanism is available under the present dollar exchange standard because the Hong Kong currency is both issued and redeemed at the same exchange rate, and that there is no exchange control of any kind. It was not available under the previous sterling exchange standard, because the Exchange Fund used different rates for buying and selling sterling and there was exchange control on sterling transactions.

By contrast, under the typical non-currency board type of fixed exchange rate regime, there is no prior foreign exchange constraint, hence there is no automatic stabiliser of any kind. The central bank may sell foreign exchange to stabilise the exchange rate for a time, but there is nothing to prevent it from issuing more notes or increasing the money supply in other ways. High interest rates not accompanied by a contraction in money supply also lack credibility. Thus, under this regime, it is indeed true that no foreign reserve is large enough to withstand persistent speculation.

Aside from the currency board system, there are several other factors that are also keys to Hong Kong's ability to defend the exchange rate.

The first is fiscal discipline. It was no mere coincidence that virtually all countries that abandoned their fixed exchange rates suffered from chronic fiscal deficits. Market players simply cannot banish the thought that the government will try to finance its huge debt through money creation. But in Hong Kong, a fiscal deficit is the exception rather than the rule. Indeed, during the past decade, the fiscal surplus increased from HK\$23.4 billion at the end of 1986 to HK\$182.2 billion at the end of June 1997.

The second related factor is that on 1 July, the day when it took over Hong Kong, China fulfilled its pledge and handed over the Land Fund, now worth some HK\$170 billion, to Hong Kong. The Land Fund had been created under the Joint Declaration to collect that portion of land sales earmarked for the future Special Administrative Region. Thus, the present Hong Kong administration has at its disposal a huge fiscal reserve of HK\$350 billion (about US\$45 billion). Furthermore, Hong Kong has virtually no foreign debt.

¹ As at end-September 1997, Hong Kong's foreign exchange reserves were more than seven times the total currency in circulation.

The third factor is that, over the past decade, the Hong Kong government has implemented a series of reforms, such as the overhaul of the regulatory system, the establishment of the Accounting Arrangements and liquidity adjustment facility, the installation of real time gross settlement system etc., which have the combined effect of strengthening immeasurably both the banking sector and the linked exchange rate. To give just one example, the average capital adequacy ratio of the banking system was 17.8 percent at the end of 1996, much higher than those in Japan, the United States, and the United Kingdom.

Critics and skeptics will, however, still insist that Hong Kong's reserves will not be sufficient if there is a confidence crisis and Hong Kong savers want to switch out of Hong Kong dollar bank deposits. It is true that Hong Kong's foreign exchange holdings at the end of June 1997 accounted for only about 23.2% of total M2 and 22.5% of total M3¹. However, the assertion that Hong Kong's reserves will be depleted in no time if there is a general run on the currency cannot bear close scrutiny. For long before the foreign exchange holdings are exhausted, the same Cantillon-Hume mechanism will be set in motion to prevent it from happening.

There is something which has not received the attention it deserves. A substantial proportion

of the bank deposits is already denominated in foreign currencies. Hence, if there is a general run, it is only the Hong Kong dollar-denominated deposits that will be subject to portfolio shift. Indeed, this shift took place massively throughout the 1980s, during which the foreign currency proportion of total bank deposits increased relentlessly from 13.8% in 1980 to 62.8% in 1990. Since then, however, this proportion has gradually fallen to 42.6% at the end of June 1997, reflecting the fact that Hong Kong people have become more confident about their future and about the Hong Kong dollar.

Failure to understand in depth Hong Kong's monetary system explains why, during the past 14 years, countless predictions of the imminent fall of the link have proved to be so grotesquely wrong. It also explains why speculators against the Hong Kong dollar have repeatedly been routed.

The remarkable stability of the Hong Kong dollar does not warrant any smugness, however, Hong Kong needs to draw appropriate lessons from the recent currency crisis in Asia. But as long as Hong Kong continues to retain the present currency board arrangement, maintain strong foreign exchange and fiscal reserves, pursue prudent macroeconomic policies, and keep a watchful eye on the banking sector, the Hong Kong dollar will be virtually impregnable. ☺

1 As at end-September 1997, Hong Kong's foreign exchange holdings accounted for about 24.5% of total M2 and 23.7% of total M3.