Frequently Asked Questions on the Linked Exchange Rate System (LERS)

1. What is the Linked Exchange Rate System (LERS)?

The LERS was adopted in Hong Kong in October 1983. The objective of the LERS is to maintain currency stability, defined as a stable external exchange value of the currency of Hong Kong, in terms of its exchange rate in the foreign exchange market against the US dollar (USD), at around HK$7.80 to US$1. The structure of the monetary system is characterised by Currency Board arrangements, requiring the Hong Kong dollar (HKD) Monetary Base[1] to be at least 100% backed by the USD reserves held in the Exchange Fund at the fixed exchange rate of HK$7.80 to US$1 and changes in the Monetary Base to be matched by corresponding changes in the USD reserves.

Under the Currency Board arrangements, the stability of HKD exchange rate is maintained through an automatic interest rate adjustment mechanism. Specifically, when there is a decrease in demand for HKD assets and the HKD exchange rate weakens to the weak-side convertibility rate of HK$7.85/US$, the HKMA will purchase HKD from banks in response to their demand, leading to a contraction of the Monetary Base. As the Monetary Base contracts, thereby reducing the level of liquidity in the interbank market, local interest rates would rise, creating monetary conditions conducive to capital inflows so as to maintain exchange rate stability. Conversely, if there is an increase in the demand for HKD assets, leading to a strengthening of the exchange rate to HK$7.75/US$, banks may buy HKD from the HKMA. The Monetary Base will correspondingly expand, exerting downward pressure on local interest rates, and so discouraging continued inflows.

2. What is a floating exchange rate system?

Under a floating exchange rate regime, the exchange value of a currency is primarily determined by demand and supply in the foreign exchange

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[1] The HKD Monetary Base comprises the following components:
(a) Certificates of Indebtedness and government-issued notes and coins;
(b) the sum of balances in the clearing accounts maintained by licensed banks with the HKMA (i.e. the Aggregate Balance); and
(c) the outstanding amount of Exchange Fund Bills and Notes.

market. But in some floating rate regimes, their central banks may still intervene in the foreign exchange markets to avoid excessive short-term volatility in their exchange rates. Nevertheless, several major advanced economies such as the US and the euro area basically allow their exchange rates to move freely and rarely intervene in the foreign exchange market.

Theoretically, in open economies with floating exchange rates, the central bank is able to employ monetary tools such as interest rates to pursue macroeconomic management. Nonetheless, exporters, importers, investors and capital fundraisers would need to hedge against exchange rate movements for their trade and financial activities, thereby increasing their cost of transaction. Furthermore, exchange rate movements, often driven by shifts in capital flows, can go out of line with economic fundamentals. If market sentiment changes abruptly, a sudden reversal of capital flows could result in huge and undesirable fluctuations in exchange rates.

If central banks want to manage both the exchange rate and interest rates, they will have to give up free international capital mobility. Nonetheless, capital controls would adversely affect the conduct of international financial intermediation and therefore are not feasible for an international financial centre.

3. Why is the LERS particularly suitable for Hong Kong?

The LERS suits Hong Kong as it is a small and open economy. As Hong Kong's economic growth is driven mainly by external factors, the cost of a more volatile exchange rate will be much larger than the cost of a volatile domestic sector. The LERS has been the anchor of Hong Kong's monetary and financial stability in the last 30 years and has proved highly resilient in a series of regional and global financial crises during this period.

Separately, even though central banks operating under a floating exchange rate regime can deploy independent monetary policy to conduct macroeconomic management theoretically, such benefits may not be realizable for small and open economies. Theoretically, they could raise interest rates or let their currency appreciate to mitigate inflation. But according to the experience of many emerging market economies, the resultant widening of interest rate spread or the appreciation of domestic currency might heighten speculations for further currency appreciation, attracting capital inflows and hot money, and thus weakening or even offsetting the effectiveness of monetary policy tightening. As such, it could intensify risks to financial markets and the wider economy by intensifying the currency appreciation pressure in the short term and hence heightening the risk of subsequent sharp currency depreciation upon abrupt reversal of fund flows. Hong Kong, being a small, open economy and international trade and financial centre, may see large fluctuations in the exchange rate of its currency should a floating exchange rate regime be adopted. This is not conducive to external trade and cross-border investment.

The experience of Switzerland in recent years further underscores the problems arising from strong capital inflows. When the European sovereign debt problems intensified, Switzerland saw huge safe-haven inflows of funds, thereby pushing up the exchange rate of the Swiss franc. As a result, economic activity slowed markedly in the third quarter of 2011. Consumer prices even dropped in October 2011. As foreign exchange interventions, quantitative easing and interest rate reduction failed to stem a continuous appreciation of the currency, the Swiss central bank set a cap on the exchange rate of the Swiss franc against the euro (at 1.2 Swiss franc per euro) in September 2011 and this subsequently dampened the deflationary pressures.

4. Under the LERS, are the loose US monetary policy and the weak USD the main drivers of the rise in Hong Kong's inflation rate in recent years?

Hong Kong's inflation depends on a number of domestic and external factors. The LERS has not been the main factor in driving inflation higher in Hong Kong. The pick-up of inflation in the past few years was partly due to global factors such as sharp increases in food and commodity prices. In fact, the HKD weakened by 4.7% against the RMB in 2011, whereas the global commodity prices increased by 26% in the same period. As global commodity prices have somewhat stabilised, inflation in Hong Kong gradually came down from 5.3% in 2011 to 4.1% in 2012. In addition, Hong Kong spends more on services than goods. Goods (including those imported) constitute only about a quarter of Hong Kong's consumption basket. Therefore, the exchange rate has not been a key factor in driving Hong Kong's inflation.

It should also be noted that our neighbouring economies, though not adopting a fixed exchange rate, still encountered significant inflationary pressures in the past few years. For example, even though the Singapore dollar appreciated by about 6% against the USD in 2012, the average inflation rate of Singapore for the same period was 4.6%, which was higher than that of Hong Kong. This supports the view that the depreciation of the HKD against the RMB and other non-USD foreign currencies is not the main reason for pushing inflation higher in Hong Kong.

5. Would a floating exchange rate regime help overcome overheating in Hong Kong's property market?

Movements in local asset prices are subject to various factors, with exchange rate being just one. Property prices are determined by a number of factors, including interest rates, demographic structure, land and housing supply, and the prospect of household income. Many emerging market economies with more flexible exchange rate regimes are not immune from the problem of influx of capital and asset bubbles in the past few years. For instance, Singapore, like Hong Kong, is also faced with overheating in the property market although the Singapore dollar has appreciated by more than 20% against the USD since the beginning of 2009. The Singapore authorities have thus introduced many measures to help cool the market, including a special stamp duty on property purchases by foreigners.

Many research studies find that monetary policy is not the most effective tool for targeting asset prices as it is difficult to confine the impact of discretionary interest rate policy to individual asset markets while leaving other financial markets and the broader economy unaffected. If used to tackle the overheated property market, interest rates may have to be raised substantially and this may cause damage to other economic sectors. Targeted and sector-specific policies relating to housing supply, and macro-prudential and demand management measures would be more appropriate tools for tackling property market overheating.

6. Is it better to peg the HKD to a basket of currencies in view of the declining value and status of the USD?

First, there is no empirical evidence to support the proposition that the USD will follow a persistent depreciation trend. The USD is still the most important international reserve currency as well as the main currency in which financial and trade transactions are denominated and settled (see A.7). It should be noted that the exchange rates between the major currencies (USD, euro, Japanese yen, and pound sterling) are the relative value of one currency against another. Although growth in the US economy is still modest, many major developed economies such as the euro area and the UK are facing similar, if not more, severe problems. While the USD exchange rate will inevitably fluctuate in the short term, it is hard to conclude that the USD is going to depreciate against other major currencies in the medium and longer term.

Moreover, a currency basket regime is still an exchange rate peg (whether be it a fixed or crawling peg), under which Hong Kong cannot have independent monetary policy. This regime lacks the transparency, simplicity and operational efficiency as compared with the existing LERS under the Currency Board System.

The local interest rate under a basket peg is supposed to be a weighted average of the corresponding interest rates of the currencies in the basket. Given the heavy weight of the US in Hong Kong's trade share, the resulting HKD interest rate under a basket peg would not differ too much from that under the LERS. Assuming that the HKD is pegged to a trade-weighted basket of the G3 currencies, the weighted 3-month HKD interbank interest rate would have averaged 0.44% in 2012, similar to the actual 3-month HKD interbank interest rate of 0.40%. A shift to basket peg will not lead to any significant change in the monetary conditions of Hong Kong, and therefore cannot help dampen consumer price inflation or overheating in the property market in Hong Kong.

7. Even though a fixed rate regime continues to serve Hong Kong well, is the USD still the best anchor currency?

The USD continues to be the most appropriate anchor currency of the HKD for the following reasons:

First, the anchor currency for the HKD must be fully convertible and can be traded freely in very large amounts in the foreign exchange market. The anchor currency should also be an international reserve currency that can facilitate foreign exchange operations and reserves management. The USD is the most commonly used currency for international trade and financial transactions. The US financial markets as well as those financial markets with transactions settled and denominated in the USD rank first in the world in terms of depth, breadth and liquidity. Moreover, having maintained low inflation in the US for over 30 years, the US Federal Reserve has a good track record in fostering price stability.

Second, despite the increasing economic integration between Hong Kong and Mainland China, economic activities in Hong Kong, as an international trade and financial centre, are more affected by trade and fund flows between the Mainland and the advanced economies than fluctuations in the Mainland's domestic economy. This is evidenced in Hong Kong's robust re-exports and offshore trade. In fact, the global economic and financial markets are still heavily influenced by the US. Hong Kong's economic cycle and financial markets are still to a large extent influenced by the financial conditions in the US and other major advanced economies.

8. In view of growing economic integration between Hong Kong and Mainland China, should the HKD be pegged to the RMB?

Despite growing economic integration between Hong Kong and Mainland China and the Mainland authorities' ongoing efforts in promoting the RMB as an international currency, it is pre-mature to consider the option of using the RMB as an anchor currency of the HKD:

First, without a fully liberalized capital account and full capital mobility, the RMB cannot be freely convertible and exchanged in large amounts. Furthermore, the offshore RMB financial markets do not yet have sufficient depth, breadth and liquidity for the Exchange Fund to hold assets to back the HKD.

Another key pre-condition for the anchor currency is that business cycles should be more closely synchronized between the two economies. But even with growing trade integration between Hong Kong and Mainland China, Hong Kong's business cycle fluctuations are still influenced more by the US and other major advanced economies (see A.7).

9. Isn't it better to peg the HKD to the RMB, given the strengthening trend of the RMB against the USD?

There is a view that Hong Kong would benefit from a peg to the RMB because it would help alleviate Hong Kong's imported inflation pressures arising from RMB's appreciation. There are also opinions that the RMB is a more suitable anchor currency for the HKD as Hong Kong and the Mainland economy have become increasingly integrated, and their economic cycles appeared to be more synchronized.

It is worth noting that Mainland China is an emerging market economy. Given the different stages of economic development and income gap between the Mainland and the advanced economies, the catch-up process tends to produce a persistent real appreciation trend of the RMB against major currencies. Since the RMB exchange rate reform in July 2005, the real effective exchange rate of the RMB has appreciated by nearly 40%, while the nominal effective exchange rate has risen by about 30%. Quite apart from the fact that the pre-conditions for considering using the RMB as Hong Kong's anchor currency do not presently exist (see A.8), a HKD peg to a currency with a persistent appreciation trend could lead to the following problems arising from competitiveness and differences in the structures of the two economies:

(1) With the appreciation trend of the RMB exchange rate in the medium term, a peg to the RMB would lead to an erosion of Hong Kong's export competitiveness as the HKD would appreciate against other major currencies. An appreciation of the HKD would reduce the competitiveness of Hong Kong's exports of goods and services, in particular the inbound tourism and related sectors. This would adversely affect the economy as exports, logistics, tourism and other related sectors account for a big share of Hong Kong's economy (about 30% in terms of both GDP and employment). Business receipts of Hong Kong's catering, retail and hotel sectors would also bear the brunt in view of the significant contribution of Mainland visitors to these sectors, which employ a large number of semi-skilled workers.

(2) Despite growing economic integration between Hong Kong and Mainland China, there remain significant differences in the economic structure and productivity growth between the two economies. A peg of the HKD to a strong and appreciating RMB would pose downward pressures on Hong Kong's domestic prices (including wages, consumer prices and property prices), or may even lead to structural deflationary pressure in Hong Kong, as the bilateral nominal exchange rate cannot adjust. To alleviate the downward pressures on wages, the only way is to increase labour productivity to lower unit labor costs. Nevertheless, as Hong Kong is a relatively mature economy, its labour productivity is unlikely to persistently grow as fast as that of the Mainland. Our estimates show that over the past 10 years, labour productivity growth of Hong Kong averaged 3-4% per annum, far lower than the average

annual growth of 10% in Mainland China[2]. Therefore, wages in Hong Kong may experience a downward pressure, thus weakening domestic demand and affecting employment and the real economy.

10. Even if the LERS is judged to be the best choice for Hong Kong, is there any scope for further refinements to enhance the LERS, such as a revaluation against the USD or a widening of the band to allow more flexibility?

Re-pegging to the USD at a new level or widening the exchange rate band will likely fail to curb inflows or contain asset price inflation. It may invite market speculations on the likelihood of further band-widening or re-pegging in the future, thereby undermining the credibility of the LERS and encouraging more speculative flows into or out of Hong Kong.

In response to the Asian financial crisis, the HKMA introduced seven technical measures in September 1998 to strengthen the Currency Board arrangements to make them less susceptible to manipulation by speculators. Furthermore, in May 2005, the HKMA introduced three refinements to the operations of the LERS, which aimed at removing uncertainty about the extent to which the HKD exchange rate might strengthen under the LERS. In the light of changing market environment, the HKMA will from time to time review the operations of the LERS and, would not rule out introducing measures to optimize the system if necessary. Nonetheless, we do not see any need to introduce such measures at present.

11. What are IMF's comments regarding the LERS?

The IMF assesses Hong Kong's monetary, economic and financial systems (Article IV Consultations) every year and has indicated support for the LERS all along. The IMF considers that the LERS is simple, credible, transparent and well understood by the public and market participants, and helps maintain the monetary and financial stability of Hong Kong.

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[2] Labour productivity measures the real output produced by each unit of labour. There are a number of methods to calculate this measure. The labour productivity figures used here are calculated as the ratio of real GDP to total employed persons. This simple method is adopted because it allows us to make comparison between Hong Kong and Mainland China as the latter does not have data on effective working hours. Figures for Mainland China come from the OECD statistics while those for Hong Kong are calculated from data compiled by the Census and Statistics Department.

The IMF is satisfied that the requirements for sustaining the LERS, including a flexible economy, a track record of fiscal discipline and robust financial sector regulation and supervision are still in place. The real effective exchange rate of the HKD remains broadly in line with economic fundamentals. The arguments for maintaining the LERS are compelling.

The IMF is not convinced by the arguments to abandon the LERS and switch to alternative exchange rate regimes. The IMF has reiterated that, for Hong Kong, the LERS is superior to any other exchange rate regime options.

12. Will the HKD be marginalised by the RMB along with the development of an offshore RMB market in Hong Kong?

While Hong Kong is developing into the largest offshore RMB centre, it does not mean that the HKD will be marginalised. In fact, whether a currency is marginalised actually hinges upon the confidence of the local residents in their own currency, that is, whether they are willing to use the currency as a means of payment and storage of value. In this connection, Hong Kong people continue to have high confidence in the HKD. Alongside an expansion in our RMB banking business, RMB deposits have grown by 12 times since the end of 2008, reaching RMB709.5 billion at the end of August 2013 and accounting for about 10% of the total deposits in our banking system. During this period, HKD deposits also rose significantly to HK$4,205.0 billion, or about 50% of all deposits in our banking system, which is the same share of HKD deposits in total deposits over the past 20 or 30 years. This suggests that RMB deposits are not growing at the expense of HKD deposits. In fact, as an international financial centre, Hong Kong’s foreign currency deposits have always accounted for around half of the total deposits in our banking system, similar to the situation in other international financial centres such as the UK and Singapore.

While the circulation and use of the RMB in Hong Kong increases as we receive more and more visitors from the Mainland, the demand for the HKD currency notes as a means for daily transactions has continued to grow. Even with the growing use of various means of electronic payment, the value of the HKD banknotes in circulation rose from HK$108 billion (8% of GDP) at the end of 2001 to HK$292 billion (14% of GDP) at the end of 2012. This clearly shows that the use of the HKD as a means of payment has not been marginalised at all.

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