Frequently asked questions

1. How are local interest rates set in Hong Kong and what is their relationship with their US counterparts?

Interbank interest rates in Hong Kong normally follow closely the movements of their US counterparts under the Linked Exchange Rate system. The size of the interest rate spread between the Hong Kong dollar and US dollar mainly reflects the premium (be it positive or negative) that investors demand on the Hong Kong dollar. Should the interest rate differential get out of line with market expectation, funds will flow to the currency with relatively higher interest rates to reap the arbitrage profits.

Retail interest rates, including time deposit rates, are determined by market forces. Likewise, the best lending rate, which is the benchmark interest rate offered by banks on their loans to customers, is subject to commercial decisions by individual banks. Given that interbank funding is a major source of funding for the banking system, retail interest rates will be influenced by movements in interbank interest rates.

2. What distinguishes a currency board system from other forms of pegged exchange rate systems?

A currency board system is a rule-based monetary regime encompassing two distinct features: full reserve-backing requirement of the monetary base, and an explicit commitment of the currency board or monetary authority to convert the domestic currency into a reserve currency at a prescribed fixed exchange rate.

The backing rule forbids central bank creation of unbacked monetary liabilities through lending to the public or the private sector. The monetary discipline so imposed, together with the explicit commitment to the fixed exchange rate between the domestic currency and the reserve currency, adds credibility to the currency board system, and has led to the perception that it is a particularly robust form of fixed exchange rate system.

3. When and how will the HKMA conduct market operations within the Convertibility Zone? Are there any rules governing the conduct of discretionary market operations?

The HKMA operates within the Convertibility Zone taking into account market conditions, including the exchange rate, interest rates, and the Aggregate Balance and other relevant market information. It will also monitor whether there are market anomalies that may arise from time to time, which may affect the smooth functioning of the Linked Exchange Rate system.

In its meeting at July 2005, the Exchange Fund Advisory Committee Currency Board Sub-Committee endorsed four broad principles that should govern operations within the Convertibility Zone: (i) all operations should be carried out in strict accordance with Currency Board rules; (ii) the primary objective of any operations should be to preserve exchange rate stability implied by the Linked Exchange Rate system and to maintain confidence in the system; (iii) operations might be undertaken to support such interest rate adjustments as would maintain exchange rate stability under the Linked Exchange Rate system and would avoid destabilising behaviour in interest rates; and (iv) operations might also be undertaken in order to remove market anomalies. While these four principles should be generally applicable for the time being, they will be kept under review in the light of experience and changing conditions.

4. *Will the Hong Kong dollar be replaced by the renminbi when the renminbi becomes fully convertible?*

The principle of "one country, two systems, two currencies" is clearly enshrined in the Basic Law. Article 111 stipulates that "The Hong Kong dollar, as the legal tender in the Hong Kong Special Administrative Region, shall continue to circulate." We do not envisage any change to the legal tender status of the Hong Kong dollar when the renminbi becomes fully convertible.

5. *What would have happened to Hong Kong during the Asian financial crisis of 1997/98 if the Hong Kong dollar had been allowed to float?*

If the Hong Kong dollar had been allowed to float in response to the devaluations of other Asian currencies, this might have triggered a spiral of further currency depreciations in the region. It is hard to predict the repercussions, but the overall consequences could have been adverse for both Hong Kong and the region. In addition, the uncertainty and disturbance caused by a change in the Linked Exchange Rate system would have significantly affected investor confidence in Hong Kong. The fact that the Hong Kong dollar is the only freely convertible currency in the region that withstood the pressures generated by the Asian financial turmoil demonstrates that the Linked Exchange Rate system has been an effective anchor for monetary and financial stability in Hong Kong.

6. How far does the Linked Exchange Rate system contribute to recession and impede economic recovery?

There is no reason to believe that the Linked Exchange Rate system is a cause of recession. However, it may intensify economic cycles in the short run, since there is no room for the exercise of independent monetary policy to moderate economic fluctuations. But, while the profile of cyclical adjustment is different between fixed and floating exchange rate regimes, the efficacy of an exchange rate regime should be judged over the longer term. In the case of a floating rate regime, external competitiveness may be quickly restored through currency depreciation. Depreciation, though, may well undermine the credibility of monetary policy and itself exacerbate financial volatility. Furthermore, depreciation may consequently reduce the incentive to search harder than before for efficiency gains within the local economy to ensure stronger economic performance over the longer term. As such, the initial competitive gains may be eroded over time. Under the Linked Exchange Rate system, on the other hand, competitiveness can be restored only through internal deflation of costs and productivity gains. The process inevitably takes time. Thus, the discipline of the Linked Exchange Rate system gives rise to a search for efficiency gains and structural reforms, which benefits the economy in the longer run.