THE IMPORTANCE OF THE LINK TO HONG KONG'S FINANCIAL STABILITY *

Since adopting the link to the US dollar and the modified currency board system, Hong Kong has had rapid growth and low unemployment. The economy has adjusted to the link, which has provided a clear and credible nominal anchor. The Chinese, British and Hong Kong authorities all support the arrangement.

Introduction

It is an honour to be invited here to say a few words about the exchange rate link, which is 11 years and 11 days old today. I will be talking about why the link has worked so well in Hong Kong and why I believe it will continue to work in the future.

For the past decade we have enjoyed steady economic growth, growing prosperity and a fixed exchange rate. It is well worth remembering that it was not always so. Recall the period before the link was introduced, when Hong Kong was on a floating exchange rate regime. In 1983, in the midst of uncertainties over the transfer of sovereignty in 1997, capital started to flow out of Hong Kong at a rapid rate. This depressed the exchange rate and began to generate sharply rising inflation, which led to a further loss of confidence in the HK dollar. The currency fell at one point to about HK$9.60 to the US dollar, from about HK$6 just over a year earlier.

During the period 1979 to 1983, inflation averaged 12% and real GDP growth swung wildly, from 11.5% in 1979 to 2.7% in 1982. I am surprised that those who support a floating exchange rate regime have so short memories.

Record of Success

Under the link, the economy has prospered. From 1983 to 1992 the average annual growth rate in per capita GDP was over 5%. According to World Bank figures, this was faster growth than any of the high-income countries. Only 12 economies in the whole world increased their per capita GDP faster than Hong Kong, the world average growth rate being little more than 1%. There are not many countries that now have a higher GDP per capita than Hong Kong.

High growth in income under the link has also led to a major structural change. Hong Kong has moved quickly from an industrialised economy in the 1980s to a service-oriented economy in the 1990s. No other economy in the world has achieved this without considerable pain or recession.

The old manufacturing jobs have not disappeared. They have just moved across the border and are still contributing to Hong Kong's national income. In my view, the linked exchange rate encouraged this capital flow abroad, benefitting both Hong Kong and China. With rising costs at home and a strong and stable HK dollar, it made sense for manufacturers to move to neighbouring areas with spare labour capacity.

At the same time, the services sector now accounts for around 70% of jobs in Hong Kong. Within this sector, finance and business services accounts for 16% of total jobs in the economy and trade and catering for 40%. This was achieved with an average unemployment rate of less than 2%, a tribute to the flexibility and adaptability of the Hong Kong labour force.

Here again, the stable exchange rate helped. For the US dollar based investor, investing in the Hong Kong financial market under the link removed the exchange rate risk. In consequence, the Hong Kong financial markets have grown rapidly in the last decade: turnover on the stock market was $124 billion in 1993, compared with $37 billion in 1983. The foreign exchange market turns over around US$60 billion per day, making Hong Kong the world's sixth largest centre for forex trading. The HK dollar debt market is growing rapidly. 379 authorised institutions are now doing business here, including 18 of the world's top 20 banks.

* This is the text of a speech given by Andrew Sheng, Deputy Chief Executive (Monetary) of the HKMA, to a seminar on "The Impact of the Link" held in October 1994.

The exchange rate link has proved resilient in the face of financial and political shocks. The 1987 stockmarket crash, the events in China in June 1989, the Gulf War in 1990, the collapse of BCCI in 1991 and the turmoil in the ERM in 1992 did not result in any change in the 7.8 rate or any marked deviation away from it.

The exchange rate link has therefore earned credibility. The best market indicator of confidence and credibility in the link is the closeness of yields on Hong Kong securities with those on US Treasuries. The recent issues of 3-year and 5-year Exchange Fund Notes which mature after 1997 with yields very close to US Treasury notes provide solid evidence that the market has discounted the risk, if any, associated with the change in sovereignty on 1 July 1997.

How does the Link work?

Hong Kong operates a currency board system, under which the three note-issuing banks issue HK dollar banknotes against holdings of certificates of indebtedness issued by the Exchange Fund. Since October 1983 these certificates have been issued and redeemed at a fixed rate of HK$7.8 to the US dollar.

More importantly, money market operations in Hong Kong are directed towards maintaining the external value of the currency. This has become easier since 1988 when the Accounting Arrangements were introduced, which allowed the Exchange Fund to influence the level of inter-bank liquidity. The ability to conduct open market operations was strengthened when the Exchange Fund Bills programme was first introduced in March 1990. The launching of the Liquidity Adjustment Facility, Hong Kong's version of the discount window, in June 1992, enabled HKMA to influence short-term interbank interest rates. Together with the potential to levy deposit charges under the Rules on Interest Rates and Deposit Charges, under Section 12(1) of the Hong Kong Association of Banks Ordinance, there is now a full armoury of monetary policy instruments to manage exchange rate stability.

In essence, when the exchange rate in the foreign exchange market is stronger than 7.80, HK dollar interest rates would be depressed through money market operations to levels below those for the US dollar, which would discourage further inflows into the HK dollar. The reverse operations are conducted when the exchange rate is weaker than 7.80.

Advantages of the Link

The policy has worked. The exchange rate has rarely moved more than 1% away from the 7.8 parity and has been on the strong side more often than it has been on the weak side. One of the biggest advantages of the Link to the man-in-the street is that it is ***simple, consistent and well understood***. Everyone can see what the exchange rate is at any time. The purpose of monetary policy is clear and singular: exchange rate stability. There is no room for uncertainty that can be generated from multiple targets of policy, such as inflation, unemployment or growth. From a theoretical and operational point of view, this policy has the best chance of succeeding. The approach is consistent with Nobel Laureate Jan Tinbergen's view that one instrument for one target is more likely to succeed than trying to achieve multiple targets simultaneously. The HKMA has one major purpose and monetary policy is clearly directed towards exchange rate stability.

Some commentators have suggested that the link should be tied to a basket of currencies rather than to just one currency. But this would be a much less tangible target. It also gives rise to a number of uncertainties. How should the weights be chosen? How often should they be revised?

A link with a basket would also be less helpful to businesses. For example, a company trading with Germany now knows the HK dollar's value will be steady against the US dollar. There are well-developed futures and options markets in which risks from movements in the US dollar/D-mark rate can be hedged. There are no such markets for the D-mark against the trade-weighted-index of the HK dollar. The stability of the link forces businesses to focus on their competitiveness, rather than speculating on the currency.

The US dollar was chosen as a widely-used low-inflation currency of one of Hong Kong's major trading partners. Furthermore, with Hong Kong's trade being largely with China and other Asian-Pacific nations, whose currencies are also managed primarily in relation to the US dollar, it is remarkably close to the basket of currencies that would have minimised the trade-weighted variability of Hong Kong's exchange rate over recent years. One study on this suggested the US dollar would have made up over 90% of such a basket.

Why does the Link work so well in Hong Kong?

Why has such a fixed rate system worked in Hong Kong when it does not seem to work well in some other economies? The following are the key reasons:

Firstly, Hong Kong maintains fiscal discipline. The Government has been running a fiscal surplus averaging over 2% of GDP for the past decade. There is no public fear that the government will ever need the printing press to fund its operations.

Secondly, the international reserves are very large. They were almost HK$335 billion, or US$43 billion, at end 1993. The Bank for International Settlements described the exchange rate link in Hong Kong as a "rather special case", arguing "the sheer size of the Exchange Fund available to defend the currency has given this commitment almost unparalleled credibility".

Thirdly, the Hong Kong economy is very flexible. The economy has been able to switch to a service economy, maintain growth, and keep unemployment low, because of its high savings rate, entrepreneurial skills and maintenance of high labour productivity.

Fourthly, the growing prosperity in China and the integration of trade and investments between the two economies have contributed to the strength of the economy that underpins the credibility of the link.

Fifthly, the Government's commitment to the link provides a useful discipline on policy. It minimises the risk of policy reversals which may appeal in the short term but harm in the longer term. In particular, it rules out the "soft option" or "quick fix" of giving the economy a temporary boost in competitiveness by changing the exchange rate. Policy attention has been focussed on the supply side of the economy, to ensure that infrastructure growth and land, labour and fiscal policies are committed to maintain Hong Kong's long term competitiveness and financial stability.

Finally, Nobel Laureate Professor Milton Friedman himself said in Hong Kong last year that a small open economy is better off linking its own currency to that of a major country, particularly one with which it has close economic relationships. He also recognised that "one essential for a monetary system is that it has some anchor". Hong Kong's linked exchange rate system clearly fits this model. The link is Hong Kong's monetary anchor.

The Link and Inflation

Of course not everyone likes a fixed exchange rate. It has meant that Hong Kong has to keep its interest rates close to those in the US. We cannot use interest rates higher than the US for demand management purposes. In recent years, when Hong Kong has been growing consistently faster than the US, interest rate levels were a bit lower than desirable for Hong Kong conditions, which led to some inflationary pressures, most obviously in property prices.

But this effect should not be overstated. The link has helped reduce inflation in the prices of traded goods. The implicit price deflators for exports and imports have both been increasing at annual rates below 3% in recent years, so it is not fair to blame exchange rate policy for recent inflation. Hong Kong has maintained its export competitiveness and if anything, slow growth of import prices have generally helped to moderate overall inflation.

The major source of domestic inflation is the price of non-tradeables (although in recent months a surge in food prices due to floods in Southern China has also temporarily added to inflation). The rapid growth of the Chinese economy has brought enormous business opportunities to Hong Kong. However at the same time the structural changes to which I referred earlier have placed strains on our resources of land and labour. We want to see the process of structural adjustment in the real sector proceed smoothly. While this is not primarily a central banking issue, the contribution the HKMA can make is to minimise uncertainty during this period by maintaining a consistent monetary anchor.

Some inflation is virtually inevitable in the current environment. It is, in a sense, the price of success and prosperity. However, we are pleased that some of the inflationary forces in the economy are starting to unwind. US interest rates have been rising this year and are likely to go higher still. Hong Kong rates have risen with them and real lending rates are now positive. Furthermore, government measures are now helping ease pressures on property prices.

For its part, the HKMA has encouraged banks to keep loan growth for residential purchases in line with nominal GDP growth, maintain a prudent 70% loan to valuation ratio and limit real estate loans to 40% of their total loan portfolio in Hong Kong. While the prime aim of these supervisory policies is to insulate the banking system, they act to dampen asset-price pressures in general. The government is also contributing to the fight against inflation by maintaining its fiscal surplus. In the 1993 fiscal year the surplus was 2.2% of GDP.

Commitment to the Link

I mentioned earlier that the markets expect the link to continue through 1997. They are right to do so; the British and Chinese sides are in agreement on its desirability. Currency stability assumes particular significance in the context of Hong Kong, in view of the change of sovereignty in 1997. For the purpose of ensuring stability and prosperity in Hong Kong, public confidence in its currency and HK dollar assets must be maintained. The linked exchange rate system has been a firm anchor for monetary stability, and has more than proved its resilience to external shocks. The Hong Kong Government is fully committed to maintaining the link. In addition to its existing monetary armoury, the HKMA will continue to review the existing mechanism for monetary management to see whether, and if so what, further reform measures would be needed to maintain monetary stability, both before and after 1997.

Let me finish on a broader note. Critics of the link fundamentally fail to see that the philosophy of the link is that the economy can adjust to the link rather than the link to the economy. The flexibility of the Hong Kong economy, its competitiveness, high productivity and the firm commitment of government all make this a durable and credible arrangement.

Perhaps I can illustrate this point with a parable. Consider three small companies in a fiercely competitive market. They have a choice of linking their price to the largest competitor in the market place, or each can adjust its price according to its own wishes.

One firm decides that as its productivity is lagging it will compete through price reductions. But price cannot compensate for shoddy goods, and very quickly this firm is out of business.

The second firm decides that it cannot increase production but will raise prices and margins. Competition quickly drives this firm into losses.

The third firm decides as a philosophy that the only way to survive in a fiercely competitive market is to deliver quality with a fixed price. It continues to improve its productivity and the quality of its product but leaves its price unchanged. Its market share rises, allowing it to both earn higher profits and pay its workers higher wages.

Hong Kong is like the third firm. Productivity gains and flexibility within an environment of a fixed world price have been the hallmarks of Hong Kong's success. There should be no complaints against Hong Kong in world fora such as the GATT. Not only do we eschew tariffs and other protective devices but we also do not seek advantage by adjusting our currency.[1]

The discipline behind the link is the philosophy of Hong Kong's free market, free enterprise strategy. The commitment to productivity gains and flexibility is as important to Hong Kong's continued prosperity as the commitment to the link.

I hope this Seminar will clarify many misunderstandings about the link and misconceptions that alternative systems are better than one with a proven record of success.

1 Although the HK dollar may depreciate against currencies other than the US dollar, this is the result of movements in the US dollar and a matter entirely out of the control of the Hong Kong authorities.