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The Future of the Monetary System of Hong Kong

by

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The Future of the Monetary System of Hong Kong

Professor the Honourable Joseph Yam^{*}, GBM, GBS, CBE, JP

I. Introduction

1. I am aware of the possible market sensitivity of my openly raising the subject of this paper, in view of my past and long involvement in monetary and financial affairs in Hong Kong in an official capacity. I am fortunate to have had the opportunity to be engaged in policy making and operation of the monetary and financial systems of Hong Kong for a total of twenty-seven years. This started when I was posted to the Monetary Affairs Branch of the Government Secretariat as a Principal Assistant Secretary at around the same time as Margaret Thatcher visited Beijing, met Deng Xiaoping and raised the future of Hong Kong in 1982. When the monetary crisis broke in September 1983, I played a supporting role in putting together some kind of a fixed exchange rate “system” and implementing it on Monday 17 October 1983. I was also fortunate to have had the opportunity of uninterruptedly nursing the system since for over a quarter of a century, modifying and strengthening it over the years until I retired in September 2009 as Chief Executive of the Hong Kong Monetary Authority (HKMA) – the central banking institution that I had a hand in establishing in April 1993. The fixed exchange rate, which has become the focus of the monetary system of Hong Kong, has survived the highly sensitive period of political transition, and two most severe financial crises in recent world history. It has served Hong Kong well for nearly thirty years.

2. But it has been almost three years since my retirement and I have not had the privilege of discussing monetary affairs with officials in Government and the HKMA in the mean time. So, my addressing the future of the monetary system of Hong Kong at this time should not necessarily imply the need for change. What I think is needed is a continuous and vigorous intellectual exercise to consider whether the monetary system is serving the public interest in the best manner possible, having regard to the special and

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forever changing circumstances that Hong Kong faces. This paper does not even answer that question; something that I think should best be left to policy makers. I only aim to articulate, before my memory fails me as I age, the many delicate issues of the subject matter, as I see them, and importantly putting them also in a historical perspective, to facilitate informed discussion amongst those, in whatever capacity, who are interested in an answer. If it helps whoever is in a position to decide whether or not there is a case for moving the system along, and accordingly act or maintain the status quo, it would certainly be a bonus to me.

3. Section II of this paper draws attention first, briefly, to the historical background of the monetary system of Hong Kong as it now stands, and secondly to the need to explore whether and if so how the monetary system could be made to serve the public interest better. Sections III, IV, V, and VI outline the important issues to be considered in shaping the future of the monetary system of Hong Kong respectively from the legal, monetary, technical and political perspectives. Section VII concludes.

4. The paper assumes a certain degree of familiarity on the part of readers in the characteristics of and the established terms used in describing the monetary system of Hong Kong. I will also not, in this paper, rehearse the general economic arguments, such as the pros and cons of floating versus fixed exchange rates, or the sensitivity of the external balance to exchange rate changes. Readers should refer to them, if necessary, in economic textbooks. With the external environment changing along with the passage of time, the periodic changes in leadership in the Hong Kong Special Administrative Region, and market perception over the credibility and independence of the HKMA unhelpfully fluctuating along with shifts in economics and politics in Hong Kong, interest in the future of the monetary system of Hong Kong will intensify, if it has not already been so. I hope that this paper can facilitate informed discussions, wherever they are held, and therefore minimize the possibility of unwelcomed market nervousness and volatility, whenever the subject is raised.

II. Serving the Public Interest

5. The monetary system of Hong Kong has, since 17 October 1983, been characterized by a fixed exchange rate. **But a fixed exchange rate cannot, of course, be an end in itself. The monetary system of any jurisdiction should be designed to serve the relevant public interests.** There are desirable objectives that are closely identified with, or relevant to, the livelihood of the people and that can be achieved by policies concerning the monetary system – price stability, full employment, sustainable economic growth, financial stability, etc. Hence discussions concerning monetary systems traditionally focus in the area of monetary policy, although there are other areas that may also be of interest. Specifically, the discussions concern the scope, instruments and targets for the exercise of monetary control to achieve single or multiple monetary policy objectives. The exchange rate obviously features in these discussions, but often as one of the tools or intermediate targets for monetary policy, particularly in externally oriented economies.

6. **The monetary crisis in September 1983 in Hong Kong had a sharp focus in the exchange rate, involving, at the height of it, a depreciation of the Hong Kong dollar against the US dollar of 15% in one and a half working days.** On Saturday 23 September 1983, the Hong Kong dollar's exchange rate against the US dollar reached 9.60. There were empty shelves in supermarkets as people scrambled in panic to stock up rice and toilet paper. Stabilization of the exchange rate was then the main concern. Indeed, the Government statement issued at noon on Saturday 15 October 1983 announcing the scheme to fix the exchange rate at 7.80 said that: "we cannot run the risk of further spiraling depreciation, with the rampant inflation and distress which that would bring to all our community. A return of confidence to our currency is essential".

7. The situation was so serious that the Government had to go for the strongest form of fixed exchange rate systems – currency board arrangements that require the domestic currency to be issued and redeemed against a foreign currency at a fixed exchange rate – although this was, at the time, the only option available. **And so the fixed exchange rate became the focus of Hong Kong's monetary system.** The fact that it has been robustly and successfully defended over the years, notably in the Asian financial crisis of 1997-98, when the HKMA aggressively intervened in the stock market to counter cross market manipulation and fend off exchange rate speculation, served to sustain that focus, to the point, some would say, of obsession or even paranoid.

8. **The need for effective monetary control to serve the public interest has, nevertheless, been an important subject matter in internal deliberations of the HKMA (and its institutional predecessor before April 1993, the Monetary Affairs Branch of the Government Secretariat) on the development of the monetary system of Hong Kong.** But in view of the possibility of such sentiment being misunderstood as a lack of commitment to the fixed exchange rate, discussions were held most discreetly and actions were taken with the utmost care. Even before fixing the exchange rate as a response to the monetary crisis in September 1983, the Monetary Affairs Branch had already identified the fundamental weakness of Hong Kong's monetary system, which

was the lack of an effective mechanism for the authorities to exercise monetary control. I can still remember the rather heated internal discussions on this sensitive subject in the early part of 1983, less than a year of my joining the Monetary Affairs Branch as a Principal Assistant Secretary, and my amazement then on the anarchical nature of the monetary system of Hong Kong. But before internal consensus was achieved on the need for such a mechanism and on how it could be put in place, the crisis had taken hold.

9. With the benefit of hindsight, if there were an effective mechanism for monetary control in place, I think the monetary crisis of 1983 might have not been so severe and might have even been avoided. With such a mechanism, the non-sterilized monetary effects of capital outflow, if necessary intensified by further money market operations, could have provided the necessary support for the exchange rate to prevent depreciation from attaining a crisis dimension. In the absence of a mechanism to generate and transmit the necessary monetary effects, Government intervention in the foreign exchange market then was rather futile. The statement of 15 October 1983 in effect admitted this; it said that: “the Government has been concerned by the falling exchange rate and has done everything in reason, within the established framework, to attempt to stabilize it. These efforts have achieved only limited success”. But it did not go as far as to admit that “the established framework” then was simply faulty and that **the lack of effective monetary control was a responsible factor contributing to the monetary crisis.**

10. The exchange rate, thankfully, stabilized soon after the currency board arrangements for the issue and redemption of bank notes, or what are now, with subsequent modifications, commonly referred to as the Linked Exchange Rate System (LERS), were implemented. Whether the stabilization was indeed the result of the LERS is, interestingly, debatable. **For a start, the system did not work as envisaged.** The currency board arrangements then could only be applied to bank notes in circulation, which are just one component of the monetary base and not the important one. There was little or no bank notes arbitrage, as enthusiastically argued then, to ensure that the market exchange rate stayed close to 7.80, the exchange rate for the issue and redemption of (Certificates of Indebtedness backing the) bank notes. Bank notes arbitrage was frustrated by bank charges on the handling of large amounts of bank notes that reflected the extent of the deviation of the market exchange rate from 7.80. **But the psychological effect of the LERS, presenting the Hong Kong dollar as an extension of the US dollar, certainly worked.** And this was helped also by the still rather frequent and discretionary exchange market intervention during the immediately following months.

11. But the Monetary Affairs Branch, and then the HKMA established later in 1993, did subsequently and discreetly put in place an effective mechanism for monetary control. A number of reform measures were carefully presented and implemented over a period to refine and strengthen the LERS. These ensured, among other things, that capital flows would, as currency board arrangements require, generate the monetary effects necessary to support the exchange rate, although this mechanism for monetary control can be deployed to achieve alternative monetary objectives as well. For obvious reasons, this latter point was not publicized. **Thus the foundation of a proper monetary system was**

successfully laid. In time, this allowed the Hong Kong Special Administrative Region Government suitably to address the subject of monetary policy a lot more comfortably, to the extent of transparently defining, as other jurisdictions invariably do to enhance policy credibility, the objective and the means of achieving it.

12. The objective of monetary policy in Hong Kong was for the first time clearly articulated on 25 June 2003, almost twenty years after the LERS was put in place. In a statement on Monetary Policy Objective by the Financial Secretary, issued in connection with an Exchange of Letter between the Financial Secretary and the Monetary Authority of Hong Kong, **the objective of monetary policy was described as “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, at around HK\$7.80 to US\$1”.**

13. The Letter exchanged also required the Financial Secretary to determine the structure of the monetary system of Hong Kong, which he did. In the same statement, it is laid down that **“the structure of the monetary system shall be characterized by Currency Board arrangements, requiring the Hong Kong dollar monetary base to be at least 100 percent backed by, and changes in it to be 100 percent matched by corresponding changes in, US dollar reserves held in the Exchange Fund at the fixed exchange rate of HK\$7.80 to US\$1”.**

14. There is no doubt that the LERS has, for almost 30 years of its existence, been a pillar of stability for Hong Kong. But, realistically there are costs involved. As with all jurisdictions operating with a fixed exchange rate, it is not possible for adjustments to economic shocks of all descriptions to work through the exchange rate. As a consequence, there is inherently a higher degree of volatility in economic activities and in domestic prices, which could be exacerbated if confidence in the determination and ability of the authorities to maintain the system wanes when the economy is under stress. **There is little or no scope under the LERS, notwithstanding the reform measures taken over the years to strengthen it, for the use of the more traditional and discretionary monetary management practised in most jurisdictions to control the price or supply of base money to achieve other desirable monetary policy objectives such as low inflation, low unemployment and stable and sustainable economic growth.** But it has to be noted that, for various reasons (for example, the lack of fiscal discipline) not necessarily of a monetary nature, not all jurisdictions with the freedom to exercise discretionary monetary policy have been successful in delivering these other desirable objectives.

15. It is always debatable whether the costs associated with having the comfort of “a stable external exchange value of the currency of Hong Kong”, in the form of a stable exchange rate against the US dollar, are worth assuming at all times, regardless of the changing circumstances that Hong Kong faces. This is particularly so, when, as widely recognized, inflation in Hong Kong has, at times, been uncomfortably high, and asset bubbles have been a feature of Hong Kong’s economic development. Clearly, both have unsettling and possibly debilitating consequences for society. For example, with inflation

currently running at nearly 5%, the appropriateness of continued involuntary quantitative easing in Hong Kong, which started in the second half of 2008, must now be questionable. **It is for consideration, therefore, whether there is scope, even in normal times, for monetary policy in Hong Kong to be made more pro-active in serving the public interest better.**

16. **The current financial crisis has also demonstrated what monetary authorities, through imaginatively exercising monetary policy, can do to help economies and financial systems in stress and communities in pain.** Although the jury is still out, central banks have been hailed as saviors. The Federal Reserve Bank in the United States has made unprecedented moves in monetary policy in support of the economy, the financial system and the debt market. The European Central Bank, notwithstanding its highly specific mandate of price stability, has also been proactively supporting the financial system and, in turn, the sovereign debt market. The People's Bank of China, working with the legal mandate of currency stability and through it the promotion of economic growth, has been referring also to employment and the external balance as additional monetary objectives. But in Hong Kong, with the LERS, there is little or no scope for special support for the economy or the financial system in crisis, unless an argument can be made that not doing so would involve unacceptable risks to the "exchange value of the currency of Hong Kong".

17. It is also debatable, however, whether or not the free and highly externally oriented economy of Hong Kong, which is required by the Basic Law not to adopt exchange control policies, can afford the luxury of having a flexible exchange rate and the freedom of conducting discretionary monetary policy, against the background of the highly potent nature of international capital. Furthermore, as an international financial centre, Hong Kong is exposed to capital flows that are, relative for example to the Gross Domestic Product, much larger than other jurisdictions, particularly when financial market activities are conducted with the use of the domestic currency as a medium of exchange. Correspondingly, the risks of monetary and financial instability that Hong Kong is exposed to are also higher, and the task of maintaining stability more challenging. **This argues for a special approach to shaping the monetary system, so that it can, on a sustainable basis, cope with the increasing demands arising from international financial activities and maintain monetary and financial stability at the same time.**

18. Meanwhile, since the establishment of the LERS in 1983, the economy of Hong Kong has increasingly become integrated with, and dependent on, the economy of the Mainland of China. With the clear prospect of the renminbi becoming an international currency, the question has also been asked often whether Hong Kong, as an integral part of China, needs to have its own currency. The Basic Law, nevertheless, specifies that the Hong Kong dollar is legal tender in Hong Kong. So, monetary policy matters in Hong Kong because it is an autonomous currency issuer. The question then becomes one of **whether, even accepting that a fixed exchange rate serves Hong Kong well, the currency anchor should not be, in the fullness of time, the renminbi instead of the US dollar.**

III. The Legal Framework

19. A discussion on the legal framework on which the monetary system of Hong Kong and possible changes to it are based should, of course, start with the Basic Law, which will be in force till 2047, although the LERS predates the Basic Law. Articles 109 to 113 are particularly relevant.

(1) *Legal Tender*

20. Article 111 specifies that “the Hong Kong dollar, as the legal tender in the Hong Kong Special Administrative Region, shall continue to circulate”. **So, unless this Article of the Basic Law is changed, the monetary system of Hong Kong, at least until 2047, will always feature the Hong Kong dollar as the legal tender.**

21. However, it is important to note, in this connection, that the use of a particular currency to perform the basic functions of money – as a medium of exchange, a store of wealth and a unit of accounting – is a matter of choice for the users. **There is no law in Hong Kong to prohibit the use or circulation of other, foreign currencies.** There used to be, in Hong Kong, a Prohibition of Circulation of Foreign Currencies Ordinance, but this was repealed in the mid eighties. The reason for repealing it was to make way for dollarization, which was at that time considered a possibility, though with a low probability, with the LERS having just been introduced and frankly not working as smoothly as it should, due to the lack of a mechanism for the effective control of the Hong Kong dollar monetary base, or rather for inflows and outflows of funds to be automatically reflected in a corresponding expansion and contraction of the monetary base respectively, a matter which was corrected only later in 1988.

22. In the absence of legal restrictions, at least in Hong Kong, it is therefore possible that, as the renminbi attains international currency status, it becomes more and more popular in Hong Kong, for example, in the payment of salaries or in day to day consumption, in addition to it being, as currently, an attractive alternative avenue for the store of wealth, given its appreciating trend. Whether or not this would happen in the fullness of time depends on the sentiment of the Hong Kong people, the progress in the internationalization of the renminbi, the trend of the exchange rate between the renminbi and the Hong Kong dollar, the relevant policy stance, if any, in Hong Kong and on the Mainland, and a host of other factors. The choice of the people must, of course, be respected. **The current legal framework within which the monetary system of Hong Kong operates does not undermine the freedom to choose by the people on the currency to be used for performing the basic functions of money.**

(2) *Issue of Hong Kong Currency*

23. Insofar as the issue of the domestic currency – the Hong Kong dollar – is concerned, Article 111 of the Basic Law also specifies that “the authority to issue Hong

Kong currency shall be vested in the Government of the Hong Kong Special Administrative Region. **The issue of Hong Kong currency must be backed by a 100 percent reserve fund.** The system regarding the issue of Hong Kong currency and the reserve fund shall be prescribed by law”.

24. Three aspects are worth noting here. **First, the requirement that the issue of Hong Kong currency must be backed by a 100 percent reserve fund is not typical of those parts of central banking laws dealing with the issue of currencies in other jurisdictions.** In accounting terms, this requires those liabilities on the balance sheet of the HKMA for the account of the Exchange Fund representing Hong Kong currency issued to be matched 100 percent by, possibly dedicated and identifiable, assets in the Exchange Fund, in order to satisfy the “reserve fund” requirement. There is no doubt that this requirement helps to enhance public confidence in the Hong Kong currency, in that whoever is holding the Hong Kong dollar (in the form of notes and coins) is comforted by the fact that there are assets of at least equivalent value held by the authorities to back it.

25. But, secondly and importantly, **Article 111 does not say in which currency the assets in the reserve fund backing the issue of Hong Kong currency should be denominated.** In other words, while currently the assets in the Exchange Fund corresponding to the liabilities arising from the issue of (Certificates of Indebtedness giving authority to the note issuing banks to issue) Hong Kong dollars are denominated in US dollars, the holding of such assets in foreign currency is not a requirement of the Basic Law.

26. As also required in Article 111, “the system regarding the issue of Hong Kong currency and the reserve fund system” is, indeed, “prescribed by law”. The Exchange Fund Ordinance is the principal law in Hong Kong dealing with the monetary system, including the currency, supported by the Legal Tender Notes Issue Ordinance. Section 4(1) of the Exchange Fund Ordinance specifies that “The Financial Secretary is authorized to issue to any note-issuing bank, to be held as cover for legal tender notes ..., a certificate of indebtedness ... and to require such bank to pay to him for the account of the Exchange Fund the face value of the notes so issued, or the equivalent in such foreign exchange and at such rate of exchange as may be determined by the Financial Secretary, to be held by the Fund principally for the redemption of such notes ...”. It is clear that the Financial Secretary can require the note-issuing banks to pay to him, instead of US dollars, “the face value of the notes so issued”, in other words Hong Kong dollars, if he chooses to do so, and keep those “reserve fund” assets denominated in Hong Kong dollars. **Thus, the assets of the 100 percent reserve fund backing the issue of Hong Kong currency, as required in the Basic Law, can be denominated in foreign currency or in the Hong Kong currency itself.**

27. It follows, thirdly, that, **should the Financial Secretary think fit, the current arrangement of issuing and redeeming Certificates of Indebtedness respectively to and from the note issuing banks against US dollars at the fixed exchange rate of HK\$7.80 to US\$1, giving them authority to issue and redeem Hong Kong dollar**

bank notes, can be done against Hong Kong dollars instead. The mechanism and the implications of this possible change are discussed in the technical section of this paper. Suffice to say here that such a change would facilitate a change in the monetary system from one featuring Currency Board arrangements to one featuring, for example, discretionary monetary management to deliver alternative monetary policy objective(s). It would also facilitate a desirable refinement to the LERS that eliminates the current inconsistency between the convertibility undertakings of two components (the note issue and the Aggregate Balance) of the Hong Kong dollar monetary base.

(3) Convertibility

28. The Government of the Hong Kong Special Administrative Region has authority over the monetary system of Hong Kong. Article 110 of the Basic Law specifies that “The monetary and financial systems of the Hong Kong Special Administrative Region shall be prescribed by law. The Government of the Hong Kong Special Administrative Region shall, on its own, formulate monetary and financial policies ...” That authority is, however, qualified by Article 112, which specifies that “**No foreign exchange control policies shall be applied in the Hong Kong Special Administrative Region. The Hong Kong dollar shall be freely convertible.** Markets for foreign exchange, gold, securities, future and the like shall continue. The Government of the Hong Kong Special Administrative Region shall safeguard the free flow of capital within, into and out of the Region”.

29. The intention of these qualifications – no foreign exchange control policies and free convertibility – is clear and reflects understandable concerns at the time of the drafting of the Basic Law. Money stays where there is no restriction on its mobility. But it has to be pointed out that they may also have the effect of constraining the ability of the Government of the Hong Kong Special Administrative Region to adopt measures that are now becoming much better accepted internationally in dealing with volatile and destabilizing capital flows, particularly those that at times are predatory in character, drawing from the experience of the financial crises of the last two decades. Nevertheless, **a case can perhaps be made that temporary and targeted “exchange control” measures do not represent “foreign exchange control policies”, which must be of a more general nature, and that free convertibility does not preclude the collection of information to enable activities to be monitored.** It is not the intention of this paper to go into the likely complex legal arguments on the case. But it would clearly be advisable for the authorities to try and articulate them thoroughly, whether as part of contingency planning or for the purpose of clarifying whether it is possible to include certain possibly quite effective measures as part of its monetary armory.

(4) Power of Control over the Monetary Base

30. While the Basic Law, at a high level, specifies that the Government of the Hong Kong Special Administrative Region shall, on its own, formulate monetary policy, there

is a need for a robust legal framework for actually doing it, allowing the authorities to determine the objective(s) of monetary policy and put in place the mechanism whereby the monetary policy objective(s) are achieved. Currently **the legal framework is contained in the Exchange Fund Ordinance**, although the original intention for the enactment of the Ordinance in 1935 probably did not have those purposes in mind. But subsequent, simple amendments to the Ordinance, notably those introduced in 1995, had the effect of putting in place a mechanism for the formulation and operation of monetary policy in Hong Kong.

31. The relevant sections are those relating to the use of the Exchange Fund (Sections 3(1) and 3(1A)) and those concerning the issue of currency (Section (4)). There is also, importantly, a technical requirement, effected by the 1995 amendments, for authorized institutions to maintain clearing accounts with the Monetary Authority (Section 3A(1)). **These provisions give effective powers of control over the monetary base to the Monetary Authority, which is a necessary condition for any monetary policy objective to be achieved. In exercising those powers of control over the monetary base, the Monetary Authority can do so either in a non-discretionary manner, as is currently the case under the LERS, or in a discretionary manner, should determinations by the Financial Secretary concerning the monetary policy objective and the structure of the monetary system justify doing so.**

(5) Monetary Policy Objective

32. There is, nevertheless, a delicate legal issue here. **The reliance on the relevant powers in the Exchange Fund Ordinance generally and on the powers to use the Exchange Fund specifically in the formulation and operation of monetary policy mean that monetary policy in Hong Kong must have a focus, “either directly or indirectly”, in “the exchange value of the currency of Hong Kong”.** Section 3(1) of the Exchange Fund Ordinance is crucial. It specifies that the Exchange Fund “... shall be used primarily for such purposes as the Financial Secretary thinks fit affecting, either directly or indirectly the exchange value of the currency of Hong Kong and for other purposes incidental thereto...”

33. “The exchange value of the currency of Hong Kong” is, however, not defined in the Exchange Fund Ordinance. It can be the external exchange value of the currency of Hong Kong against any foreign currency, whether it is the US dollar, or the renminbi, or a basket of foreign currencies. Thus, **should it be considered appropriate, the powers in the Exchange Fund Ordinance can be exercised for the purpose of maintaining, for example, a stable relationship between the Hong Kong dollar and the renminbi, instead of, as now, a fixed exchange rate between the Hong Kong dollar and the US dollar.**

34. But the important question that should be answered is, should it be considered desirable to change the objective of monetary policy from a stable exchange rate against the US dollar to, for example, price stability, whether it is also legally possible under

existing law. I am not a lawyer and therefore not qualified to express a legal opinion. For what they are worth, however, I think there are three supportive arguments.

35. First, **“the exchange value of the currency of Hong Kong” can refer to either the external exchange value or the internal exchange value.** This distinction is envisaged in the statement on Monetary Policy Objective by the Financial Secretary on 25 June 2003, in connection with the Exchange of Letters between him and the Monetary Authority, in which he defined “currency stability” as “a stable external exchange value of the currency of Hong Kong”. The use of the word “external” to qualify “the exchange value of the currency of Hong Kong” was deliberate. The external exchange value of the currency of Hong Kong is, obviously, the value by which the Hong Kong dollar can be exchanged for foreign currencies, or the exchange rate, so as, for example, to facilitate importing what Hong Kong needs. The internal exchange value of the currency of Hong Kong is, correspondingly, the value by which the Hong Kong dollar can be exchanged for goods and services in Hong Kong, which can be measured by various price indexes, the most prominent of which is the Consumer Price Index. **Thus, the Exchange Fund can legitimately be used for the alternative purpose of, for example, controlling inflation in Hong Kong.**

36. While this distinction between the external and internal “exchange value of the currency of Hong Kong” is economically sound, the corresponding references in the Chinese translation of the Exchange Fund Ordinance and, more importantly, in the Basic Law make it questionable. **The terms “港幣匯價” and “港元匯價” are used respectively, suggesting that when the documents were translated and promulgated respectively, the drafters had the Hong Kong dollar exchange rate in mind.**

37. However, secondly, Hong Kong is, in any case, a highly externally oriented economy with external trade representing about three times the Gross Domestic Product. There are no natural resources and almost everything consumed in Hong Kong have to be imported. The domestic price level, therefore, is highly dependent on the exchange rate of the Hong Kong dollar, so that **in maintaining price stability as an objective of monetary policy, there is a need for monetary policy operations to have a strong focus in maintaining stability in the exchange rate,** however defined, whether it is against a single foreign currency or a basket of foreign currencies. In other words, the exchange rate should technically be the intermediate target. **The use of the Exchange Fund to target the exchange rate in order to deliver price stability is, therefore, a legitimate use of the Fund.**

38. Thirdly, exchange rate stability can only be maintained in the long term through the adoption of prudent macroeconomic policies, including the maintenance of price stability. Persistently high inflation undermines exchange rate stability. **The use of the Exchange Fund in delivering price stability indirectly affects “the exchange value of the currency of Hong Kong”, even interpreting that narrowly as the exchange value against foreign currencies, and is therefore allowable under Section 3(1) of the Exchange Fund Ordinance. Furthermore, incidental to affecting the exchange value of the currency of Hong Kong is the need to maintaining price stability and the**

latter is, therefore, a legitimate purpose “incidental thereto” for the use of the Exchange Fund.

(6) *Central Banking Law*

39. The Exchange Fund Ordinance is, admittedly, an unusual piece of legislation, when compared with those in other jurisdictions that prescribe the framework for monetary policy, which typically is in the form of a central banking law that establishes the central bank, lays down its mandates, including importantly that in respect of monetary policy, the governance arrangements, its authority, accountability arrangements, etc. But this peculiar legal framework for the monetary system of Hong Kong has been suitably buttressed by transparent administrative arrangements defining clearly, through an Exchange of Letters on 25 June 2003 between the Financial Secretary and the Monetary Authority, as to who has responsibility over what in monetary policy – the Financial Secretary determines the objective of monetary policy and the Monetary Authority delivers it independently. It is arguable whether this legal framework should, in the fullness of time, be replaced by a more traditional one, but this is not a subject matter for this paper. **What seems to be important is that the existing legal framework works well, as exchange rate stability in Hong Kong over a period of delicate political transition and global financial crises testifies.**

40. **Given the three supportive arguments above on the use of the Exchange Fund, there is no reason why this legal framework cannot continue to work well into the future, up to 2047, even with a change in the monetary policy objective.** The same should be the case beyond 2047, if there is no replacement for or change to the Basic Law to prescribe different monetary arrangements, such as for the renminbi, rather than or in addition to the Hong Kong dollar, to be legal tender in the Hong Kong Special Administrative Region.

IV. The Monetary Considerations

41. Monetary policy is not the only important aspect of a monetary system. In any market economy, there is the fundamental need for money to serve as a medium of exchange, a store of wealth and a unit of accounting; although these basic functions of money, and money itself, in different forms, are matters that have been taken for granted. For a currency reliably to perform these basic functions of money, it needs to command in a sustainable manner the confidence not only of those using it but also of those trading in it. This is obviously the responsibility of the authorities, typically in the institutional form of a central bank or a monetary authority. Confidence in a currency comes crucially from the stability in its value, and so the central bank or monetary authority is invariably given the necessary powers of control over the availability and price of money, in the form of the domestic currency, so as to maintain monetary stability, however defined. Hence the traditional focus in monetary policy whenever the subject of money is discussed at a macro level.

(1) Domestic Money

42. **Hong Kong is probably unique in that, notwithstanding not being a sovereign state, it has its own currency.** The currency – the Hong Kong dollar – has been in existence for a long time, playing the roles of money in Hong Kong, overall quite effectively; although confidence in it did breakdown in the early eighties, culminating in the monetary crisis of September 1983, partly for political reason, as the focus on the future of Hong Kong after 1997 sharpened then, and partly the result of the serious lack of effective monetary control, a matter that took quite a few years (partially in 1988 and then fully in 1996) to correct.

43. The Hong Kong dollar is the legal tender of Hong Kong and the currency that is used by the people of Hong Kong as the medium of exchange in their day to day transactions, for example, in the payment of salaries and in consumption. The great majority of them keep the bulk of their wealth in financial and other assets denominated in the Hong Kong dollar. They also account for their assets and liabilities mostly in the Hong Kong dollar. This is notwithstanding the fact that, as mentioned earlier in this paper, there is no law that prohibits the circulation and use of foreign currencies in Hong Kong, as long as the parties to a particular transaction are happy about its use. **This general acceptance of the Hong Kong dollar by the Hong Kong people obviously reflects the natural affinity of any population to its domestic currency and, importantly, the strong public confidence in the Hong Kong dollar, which has a long history of stable external value.**

44. But these are factors that should not be taken for granted. Reflecting different underlying economic dynamism, market sentiment has been that the currency anchor of Hong Kong – the US dollar – is on a long term weakening trend, and the currency of the economy upon which Hong Kong is becoming highly dependent – the renminbi – is on a long term strengthening trend. Indeed, with prices in China still substantially below

those in its trading partners, the real effective exchange rate of its currency must appreciate, as China further embraces globalization through reform and liberalization. The policy alternatives here are allowing the nominal exchange rate to appreciate or tolerating a high rate of inflation; the choice is clear. Thus, we saw, in recent years, significant appreciation of the renminbi against the US dollar, made possible by China introducing flexibility to the exchange rate in 2005 as part of its strategy on financial reform and liberalization. The rate of appreciation of the renminbi against the US dollar has, however, been rather steady since, notwithstanding a chorus of international calls for much sharper appreciation, pointing to the persistent trade surplus that China has been running. There was also a pause in the appreciating trend for around two years (2008 to 2010) as China coped with the global financial crisis originating from the developed markets. In the circumstances, thankfully, **there has not been any noticeable change on the part of the Hong Kong people in their acceptance of the Hong Kong dollar as the choice currency for organizing their affairs, although the renminbi has become more and more popular as a store of wealth.**

45. **However, many have in the mean time expressed concerns over the weakness of the Hong Kong dollar and raised questions over the continued appropriateness of the LERS for Hong Kong, particularly with uncomfortably high inflation and with Hong Kong dollar interest rates at near zero.** Going forward, therefore, it is possible that the trend of appreciation of the renminbi against the US dollar, particularly if it sharpens, may start to exert a possibly intensifying influence on the general attitude of the Hong Kong people towards the Hong Kong dollar. Specifically, it is possible that their willingness to use the Hong Kong dollar in playing the various roles of money and their continuing support on monetary policy in Hong Kong in the form of the LERS may wane over time. The declared intention of China in further enhancing flexibility in the renminbi exchange rate (witness the widening of the daily trading band to 1% on either side of the daily fixing on 16 April 2012), prospects of further and more significant exchange rate appreciation against the US dollar (and so the Hong Kong dollar) as economic and financial reform and liberalization progress, and continuing global political attention on the renminbi, may exacerbate this possible shift of attitude. **This is a matter that the authorities can ill afford to ignore.**

(2) *International Money*

46. Meanwhile, however, **the Hong Kong dollar has, interestingly, attained an international dimension over the years, in the sense of it also playing the role of money in international finance.** This is a consequence of the development of Hong Kong as an international financial centre, rather than a reflection of any effort by the Hong Kong authorities to internationalize the Hong Kong dollar. This international use of the Hong Kong dollar is not so much the use of it geographically outside Hong Kong as a medium of transaction or as a store of wealth, although this did happen for a time and mostly on the Mainland of China, before the introduction of flexibility and the subsequent appreciation in the renminbi exchange rate, when the Hong Kong dollar had been quite popular, particularly in the Guangdong province. It is the much more

significant use of the Hong Kong dollar by non-residents in financial intermediation generally and in stock market activities (initial public offerings and secondary market trading) specifically in Hong Kong, as the financial markets of Hong Kong became internationalized.

47. With continuing capital controls, one form that financial reform and liberalization took on the Mainland of China was to allow Mainland companies to raise the funds they need offshore. At the same time, with the economic prospects of China being much more attractive than that of the rest of the world, particularly the developed markets, foreign investors have developed a strong appetite for financial products from China. **With supporting policies from the Mainland and the many advantages of Hong Kong as an international financial centre, the fund raisers from the Mainland and the investors from the rest of the world have simply found the free and open Hong Kong a convenient place to meet for financial intermediation.** To a lesser extent hitherto, but with clear prospects of this also taking off when Mainland policies allow, **there should also be matches between the risk appetites of Mainland investors and the risk profiles of fund raisers from the rest of the world.** With the right moves and continuing support from policy makers in Beijing, Hong Kong stands a good chance to be the choice financial centre also for this aspect of international financial intermediation between the Mainland of China and the rest of the world.

48. In internal strategic discussions on this subject, at the turn of the Century when I was still Chief Executive of the Hong Kong Monetary Authority, I raised the related question of whether the Hong Kong dollar is also the choice currency to play the relevant roles of money (as a medium of transaction and a store of wealth) in respect of international financial intermediation between the Mainland of China and the rest of the world. I noted, however, that investors and fund raisers did not really have a choice but to use the Hong Kong dollar in conducting financial market activities in Hong Kong, and that the Hong Kong dollar, being de facto an extension of the US dollar by virtue of the LERS, was probably not a matter of concern to them, as long as the foreign exchange market for trading the Hong Kong dollar against convertible foreign currencies provides a mechanism for the exchange rate risks to be appropriately managed. **But there could be circumstances whereby the exposure to the Hong Kong dollar, possibly considered incidental at this point of time, becomes a concern, to the extent of limiting the utility of the financial markets of Hong Kong to foreign investors and fund raisers.**

49. I raised the question also for another reason, which is whether the huge flow of capital in and out of the Hong Kong dollar, and the credit creation in the Hong Kong dollar money market, every time there is, for example, a large initial public offering that is many times oversubscribed, is conducive to the maintenance of monetary and financial stability in Hong Kong. There are obviously implications of the increasingly large presence of foreign owned, agile money denominated in Hong Kong dollars for monetary and financial stability in Hong Kong. As Hong Kong becomes more and more successful as the international financial centre of China, there will be more foreign (including Mainland) money undertaking financial activities that will become increasingly complex, involving the use of leverage and derivatives. Their volume and complexity could

overwhelm the domestic financial activities that serve the rather small Hong Kong economy. Their behavior, which understandably pays relatively less regard, if at all, to the long term public interest of Hong Kong, could well cause short term volatility in financial markets, particularly in the Hong Kong dollar money market, that is too sharp for the domestic economy – witness the 1997-98 experience. In brief, the key question to be answered is the following. **Is it realistic to expect the monetary system of a jurisdiction with 7 million people, if it keeps its domestic orientation, with the domestic currency continuing predominantly to perform the roles of money, to continue meaningfully as an international financial centre to serve the needs of international financial intermediation between a jurisdiction with 1.3 billion people and the rest of the world, and maintain domestic monetary and financial stability at the same time?**

50. This is a difficult question to answer authoritatively. There is no precedence of an international financial centre of Hong Kong's scale operating with a domestic currency system that is not the national currency system of a much bigger economy. New York does not have a separate currency system and it has the whole of the United States naturally using it to organize finance, domestic as well as international. London has the whole of the United Kingdom, although probably as a reflection of choice or demand much of the financial activities there are conducted using the US dollar or the euro, which has relevance to Hong Kong's further development as an international financial centre. And there is no internationally established threshold in, for example, the ratio of international finance to the domestic economy beyond which risks to monetary and financial stability would rise disproportionately. The size of the financial system (real activity rather than just booking) to gross domestic product in Hong Kong is probably already the highest in the world. The amount of money raised in IPOs in the Hong Kong stock market has been top of the world for a few years in absolute terms, not to mention when measured as a percentage of GDP. **In attaining these laurels and successfully maintaining the status of Hong Kong as an international financial centre, as required in the Basic Law, are we incurring monetary and financial risks that may adversely impact on the domestic economy and the people of Hong Kong, and are we managing those risks prudently?**

(3) *Financial Infrastructure*

51. Thus Hong Kong has been in uncharted waters for some time and one way that has been identified to steer it is **the construction of a multi-currency financial infrastructure, making it possible for international financial intermediation to be conducted in Hong Kong also with the use of major foreign currencies.** While the choice of currency is still to be left to the market participants, the financial infrastructure should make allowance for financial instruments to be listed, quoted, priced, traded, transacted, paid, settled, cleared, etc, in Hong Kong also in the foreign currencies. This strategy, by not forcing large flow of capital in and out of the Hong Kong dollar, has the dual benefit of better satisfying the risk preferences (particularly currency risks) of foreign investors and fund raisers, and better safeguarding the stability of the monetary

system of Hong Kong. This strategy was first put into practice in the year 2000 with the replication of the Hong Kong dollar Real Time Gross Settlement (RTGS) inter-bank payment system, put in place in 1996, for the US dollar and linking up the two payment systems to provide for real time payment versus payment (PVP) across the two currencies. It was later extended further to provide RTGS payment facilitates for the euro in 2003 and, importantly, for the renminbi in 2007.

52. **This move in the inter-bank payment system of Hong Kong into a multi-currency mode, which is quite unique, was intended to be followed by corresponding moves in the infrastructure of the individual financial markets, particularly those in which international participants are active.** But progress has been slow. The reason perhaps is that there has not been significant market demand, for example, for shares also to be listed and traded in foreign currencies as well as the Hong Kong dollar. Where there were the rare attempts to have shares listed in, for example, the renminbi, the level of interest in the primary market has been relatively subdued and subsequent activity in the secondary market has been rather low. Support from the intermediaries has, therefore, also been lukewarm, if that. Perhaps inertia and vested interest also played a part in the slow progress. Adding to this may be the strong sense of comfort (hopefully not a false sense of security), built up over the years, on monetary stability in Hong Kong.

53. But there is no doubt, for the reasons identified, that **faster and further progress in the implementation of this strategy is warranted.** The internationalization of the renminbi, led by the proactive policies of the Mainland authorities in promoting its greater use offshore, and the corresponding continued development of renminbi business in Hong Kong, should hopefully give this the necessary boost. Further, seen just from the point of view of the maintenance of the status of Hong Kong as an international financial centre, there seems a need, as quickly as Mainland policies permit, to form a critical mass of renminbi financial activity in Hong Kong, in order to reduce the chances of the marginalization of Hong Kong by the eventual, though gradual, liberalization of capital account controls on the Mainland. **Whatever advantages that Hong Kong has, as an international financial centre, for example, the rule of law, robust financial infrastructure, professional skills, etc, it is still the middle man that always faces the risk of being sidelined when the principals can deal directly with each other.**

(4) *Monetary Freedom*

54. With monetary arrangements that facilitate the convenient use of foreign currencies in serving the needs of international investors and fund raisers in their international financial activities in place, that part of the monetary system of Hong Kong featuring the domestic currency – the Hong Kong dollar – playing the roles of money can and will, desirably, become more domestically oriented. **The risks to (domestic) monetary stability will be reduced and the scope for pursuing alternative monetary policy objectives, if any, that possibly better serve the public interest will correspondingly be increased.**

55. I must add quickly here one important point to make sure that the intention of this paper is not misunderstood. It is debatable on whether greater freedom to pursue, for example, the rather more popular monetary policy objective of price stability, which must of course be in the public interest in all jurisdictions, for an economy as externally oriented and as committed to openness as Hong Kong, is necessarily good for Hong Kong. The arguments for and against fixing the exchange rate and conceding the freedom over monetary policy are well rehearsed in academic and financial literature; so are the pros and cons of exercising discretionary monetary management with a floating exchange rate. There are also many other variants of monetary arrangements that work well for individual jurisdictions, having regard to their specific, domestic characteristics. And nothing is absolute or sacrosanct. Circumstances do change. The important thing is for the authorities to be on top of the subject and be seen to be so, although extraordinary attention of the authorities on the monetary system are realistically market sensitive and subject to all sorts of interpretations, not necessarily all helpful. Outside of the official circle, however, open and objective discussion, which helps policy making, should always be encouraged, particularly when, as I mentioned earlier in this paper, external developments are such that public concern in Hong Kong and international market attention on the subject matter is likely to intensify over time. **Monetary reform need not always be crisis driven.**

56. Monetary freedom, it is often said, is not something that Hong Kong can afford, because of its financial openness and external orientation, both mandated in the Basic Law, respectively prohibiting the application of foreign exchange control policies and requiring the maintenance of the status of Hong Kong as an international financial centre. But international financial activities conducted in financial markets in Hong Kong need not exclusively be organized and denominated in the Hong Kong dollar. If so, this amounts to forcing investors and fund raisers to assume exchange rate risks that they may wish to avoid and Hong Kong to assume risks to monetary and financial stability that are greater than otherwise would be the case. Both areas of risk would grow if Hong Kong's role as an international financial centre is to grow further. There must be doubt as to the sustainability and, indeed, the desirability of such growth, because, in the fullness of time, either the continuing role of Hong Kong as an international financial centre or the monetary and financial stability in Hong Kong may be tested. **The greater use of foreign currencies in the international financial activities conducted in Hong Kong would reduce the two types of risks identified. And it may be that, as a result, Hong Kong can then afford the monetary freedom that other jurisdictions have and pursue alternative monetary policy objectives that are considered to be in the greater public interest of the people of Hong Kong.**

V. The Technical Considerations

57. Whether, and if so what, alternative monetary policy objective(s) should be determined for Hong Kong are matters for the Hong Kong Special Administration Region Government. I am sure that, in accordance with established practice, these are matters of continuous internal review and contingency planning, at least within the HKMA. In this connection, there are practical considerations of great importance, namely, whether or not, technically, the monetary arrangements in Hong Kong allow for smooth transition and for the alternative monetary policy objectives to be effectively pursued; and whether the HKMA has the technical capability to deliver.

(1) *Monetary Control*

58. Whatever is the monetary policy objective, in achieving it the central bank principally aim to control the supply and/or the price of base money. On this, the Hong Kong Monetary Authority is in a position to do so effectively. This is the result of monetary reform measures discreetly implemented over the years. Up until July 1988, the Hong Kong dollar monetary base had been an indeterminate entity, being the result of commercial activity of the Hongkong and Shanghai Banking Corporation Limited (HSBC) as the Settlement Bank of the Hong Kong Association of Banks. Understandably, the private interests of the commercial bank in profit maximization may often be in conflict with the public interest of maintaining currency stability, however defined, through exercising effective monetary control. **This was a most peculiar situation, in terms of central banking, in that, before July 1988, the authorities had no effective means of control over the monetary base and a commercial bank had the power to create money.**

59. The LERS, as it was first introduced in October 1983, did establish some control over the issue and redemption of banknotes by the Note Issuing Banks, through requiring them correspondingly to acquire and retire Certificates of Indebtedness at the Exchange Fund against US dollars at the fixed exchange rate of HK\$7.80 to US\$1. But **there was no control over the crucial element of the monetary base**, being the amount of inter-bank liquidity, or the total of the balances in the clearing accounts of banks, or the reserve balance of the banking system in jurisdictions where there are reserve requirements.

60. It was only through the “Accounting Arrangements” introduced in July 1988 that indirect control by the authorities, then in the form of the Monetary Affairs Branch of the Government Secretariat, which has responsibility over the management of the Exchange Fund, was established. HSBC, as Settlement Bank of the banking system, was required through the Accounting Arrangements to operate an account at the Exchange Fund and maintain a balance there that is not less than the net clearing balance of the banking system. **The control was indirect in the sense that the authorities only established an umbilical cord to the banking system through the account that HSBC maintained at the Exchange Fund.** But it was the most that could have been achieved and very much the result of compromise, given the powers of influence of the key players then, and the

legitimate concern that the move to acquire monetary control could be misunderstood as an intention to abandon the LERS. It was also a matter that had implications for Hong Kong in political transition and therefore needed the blessing of Beijing and Whitehall, which thankfully was forthcoming, given the clear benefits of more effective monetary control in Hong Kong.

61. **It was not until 1996 that full control over this critical element of the monetary base was established.** The opportunity presented itself when necessary reform to the inter-bank payment system was introduced, in the form of the robust RTGS system for the Hong Kong dollar, which enabled settlement risks to be managed and contagion within the banking system to be minimized. All banks were then required to switch their clearing accounts held directly or indirectly with HSBC to the HKMA, for the account of the Exchange Fund. Thus the balance of the banking system, or the amount of inter-bank liquidity, or what is now commonly referred to as the Aggregate Balance, was put onto the balance sheet of the Exchange Fund as a liability item and subject to the full and direct control of the HKMA. This arrangement is essentially the same as that in other jurisdictions where commercial banks clear with the central bank. In other words, **the HKMA is in a position to control the supply and/or price of the monetary base as effectively as any other jurisdiction.**

(2) Form of Control

62. But unlike other central banks, **the HKMA currently controls the monetary base in a largely non-discretionary manner through rule-based arrangements, whereby the Aggregate Balance is altered principally through passive purchases and sales of the US dollar against the Hong Kong dollar at pre-determined exchange rate levels (buying US dollars at 7.75 and selling at 7.85).** These are the currently well known Convertibility Undertakings, although it took the HKMA a few steps over a few years eventually to move to this position, largely the result of having to be cautious and to take account of prevailing sensitivities. The non-discretionary, rule-based control is in accordance with Currency Board arrangements for delivering a stable exchange rate and has the advantage of enhancing credibility and therefore sustainability of the system. The operation of the system is also entirely transparent to facilitate scrutiny by the market. Hong Kong is probably the only jurisdiction that publishes on a real time basis the Aggregate Balance, or the amount of liquidity in the banking system, the crucial element of the monetary base, and gives explanations when there are changes.

63. The majority of central banks exercise control over the monetary base in a discretionary manner to achieve their monetary policy objectives, the most popular one being price stability. Even when the monetary policy objective is exchange rate stability, against an anchor currency or against a basket of currencies, at a particular level or steering it on a particular path (as in Singapore), direct exchange market intervention or indirect money market intervention are invariably conducted in a discretionary manner. **With discretion comes flexibility, in terms of the timing and the frequency of action, and in terms of its orientation, which could place differential emphasis on the**

quantity or the price of base money, to take account of the special circumstances or special policy preoccupations at the time. With flexibility comes, it is hoped, greater effectiveness of policy actions and greater scope to pursue the public interest, to the extent that it is appropriate for the central bank to do so. The down side risk is, of course, that central bankers, being human beings, do make mistakes in exercising discretion. As a result, credibility of the central bank and the monetary policy it is pursuing may be affected, particularly when the central bank is less than effective in communication or when it is taking on much more than it can handle, whether or not under political pressure to do so, given the lack of monetary tools at its disposal.

64. But there are many examples of central banks engaging in discretionary monetary management that enjoy strong credibility. Clarity of mandate, independent authority, professional conduct, transparency of actions, and effective and timely communication are all factors that contribute to the credibility of central banks and the policies they pursue. The HKMA possesses all those attributes, although there is always room for improvement; and it is fortunate to have established domestic as well as international credibility, notwithstanding its short history. This is not, speaking from experience, because of the lack of discretion, and therefore the lack of scope for making blunders, in operating the LERS. There has been much emphasis within the organization in intellectual debate and research, openness and frankness in addressing issues and in communication with the market and the public, and a sincere desire to work with the financial industry. In my opinion, **the HKMA is well positioned to exercise discretionary monetary management, or discretionary control over the monetary base, if it is called upon to do so.**

65. **But there is a continuing need, generally on the part of policy makers in Hong Kong and specifically in the HKMA, to deepen their understanding of the relationship between the supply and price of base money, which is under the full control of the authorities, and economic variables other than the exchange rate, particularly if there is to be a change in the monetary policy objective.** If, for example, price stability is to be the new objective of monetary policy, then obviously research work on how consumer and asset prices respond to changes in the supply and price of base money, or more generally on the monetary policy transmission mechanism, will have to be given much greater attention, particularly within the HKMA. Such technical knowledge will greatly facilitate the building up of skills for effectively exercising discretionary monetary management.

(3) *To Be or Not To Be*

66. It should be noted here that the HKMA does have some, though probably small, scope for engaging in discretionary monetary management for whatever desirable purposes, as long as exchange rate stability is not affected. **Between the strong and weak side Convertibility Undertakings of 7.75 and 7.85 is a Convertibility Zone of 1,000 pips of the exchange rate, within which the HKMA has the freedom to conduct foreign exchange and money market operations.**

67. There is, of course, **doubt on whether discretionary monetary management within such a narrow Convertibility Zone can produce meaningful results.** The purists in monetary economics are likely to argue that the money market effects of any discretionary action, taken for whatever purpose, would inevitably lead to the exchange rate hitting either of the two levels of the Convertibility Undertakings, generating involuntary exchange transactions at the HKMA that have money market effects that offset those arising from the discretionary actions. Given also that there is always the risk of such action being misunderstood as a prelude to abandoning the LERS, they would argue further that the HKMA would be ill advised to get involved in discretionary monetary management, however tightly it is circumscribed.

68. On the other hand, **empirical evidence does not suggest that the theoretical relationship between the exchange rate and money market conditions always holds.** Indeed, there have been sustained periods in which the relationship between the exchange rate and the interest rate differential between the Hong Kong dollar and the US dollar was anomalous within the Convertibility Zone, for example, an interest rate discount for the Hong Kong dollar against the US dollar coinciding with the exchange rate being on the strong side of 7.80. There have also been periods in which the theoretical inverse relationship between the size of the Aggregate Balance and the levels of inter-bank interests broke down. This suggests perhaps a need for the HKMA to act to counter the anomalies, if only for the purpose of making sure that the LERS is operating smoothly.

69. But there was **no firm conclusion as to whether or not the small room for exercising discretion should be explored or experimented,** although there have been ad hoc attempts by the HKMA to conduct discretionary money market operations to reduce the Aggregate Balance substantially through the issue of additional Exchange Fund paper. The purpose, if I remember correctly, was to lessen the likely impact and smooth out the likely exchange rate and money market effects of the eventual reversal of capital inflow, which has yet to materialize. But I must confess a secret thought that did come across my mind when the matter was discussed internally, a thought that I did not share with my colleagues at the time, and this is **the possible, undesirable effects of the very large Aggregate Balance on credit creation, inflation and eventually on exchange rate stability.** There was also, by extension, the secret thought of the introduction of reserve requirements to limit the credit creation potential of the Aggregate Balance.

70. Being public sector institutions serving the public interest, central banks are often called upon, particularly in difficult times when the community is in pain, to exercise whatever privileged influence they have on money so as to help, for example, in stimulating economic growth and employment, or in the maintenance of financial stability; although these desirable objectives may not be explicitly included in, or can only be justified by very liberal interpretations of, their legal mandates. This became quite obvious in the ongoing financial crisis originating in the developed markets, where central banking mandates are well established, characterized by clarity and focus. **There has therefore recently been a noticeable shift of support, when considering central**

banking mandates, from defining a clear, single monetary policy objective to considering multiple objectives, with relative emphasis among them reflecting prevailing economic circumstances. On the Mainland, for example, where increasingly it is accepted, and articulated repeatedly in statements from the People's Bank of China, that monetary policy aims to maintain currency stability, promote economic growth, promote employment and achieve external balance. This is notwithstanding the rather more restrictive mandate articulated in Article 3 of the People's Bank of China Law, which says that "monetary policy objective is to maintain stability in the value of the currency and, through this, to promote economic growth". Central banks in the developed markets have also, in recent years in helping the community to cope with the financial crisis, been exercising their authority over money much more imaginatively and flexibly to achieve macroeconomic objectives that are considered in the public interest.

71. **Whether or not there is meaningful scope for the HKMA in monetary policy to serve the public interest better is a matter that perhaps needs to be addressed by those concerned, if only to confirm that it currently does not exist, notwithstanding the privileged central banking authority it now possesses over money.** It takes courage, particularly in the current political environment of Hong Kong, for any public officer with responsibility over this to admit that there is a need to move on, and even more courageously to act on it, given the much easier alternative to insist on the maintenance of the status quo, a matter to be discussed further in the section on political considerations. What needs to be pointed out in this technical section are the many possibilities for creating that meaningful scope through, for example, significantly widening the Convertibility Zone, and/or having it move in a particular direction along with time, kind of like the Singaporean system where the Monetary Authority of Singapore periodically determines the centre, the slope and the width of the band of the exchange rate of the Singaporean dollar against an undisclosed basket of currencies. The Convertibility Undertakings can also be replaced by an indicative band width to be maintained by discretionary exchange market intervention, or indeed be withdrawn altogether.

(4) *Control Mechanism*

72. **The mechanism for effective monetary control already exists at the HKMA. There are quantitative tools to alter the size of the Aggregate Balance, in other words, to change the supply of Hong Kong dollar liquidity.** The HKMA can buy and sell assets, or borrow and lend, and having the transactions settled through the clearing accounts that the banks maintain with it for the account of the Exchange Fund. Money market operations traditionally practised nowadays involve the central bank buying and selling of, or entering into repurchases and reverse repurchases agreements in, specified domestic assets, which are largely in the form of government debt. In Hong Kong, although there is no government debt, given the healthy state of the public finances, which do not require deficit financing, there is a large pool of Exchange Fund paper of various maturities built up since the early nineties to serve as the specified assets. They are, in fact, liabilities on the balance sheet of the Exchange Fund, and so there is no

question about the HKMA assuming unacceptable credit risks. There is also a very liquid market for such paper and the banks are already used to managing their liquidity through this market. For example, Exchange Fund paper is currently being used by banks for the automatic intraday repurchase arrangement, a feature of the Hong Kong dollar RTGS payment system, to facilitate smooth inter-bank payments during the day. It is also used for obtaining overnight liquidity from the HKMA through the discount window. The HKMA can, of course, buy and sell foreign assets as well to change the size of the Aggregate Balance.

73. There are also the established price tools in the form of the Base Rate for accessing the Discount Window and the penal premium over it to discourage excessive dependence on the HKMA for liquidity. The Base Rate is currently priced against the Fed Funds Target Rate in the United States, which is a necessary feature of the LERS, as Hong Kong dollar interest rates should largely track those for the US dollar with the exchange rate fixed. But these price tools can be independently determined by the HKMA, should this be considered appropriate under alternative monetary arrangements. For example, **it should be quite simple for the HKMA to determine a new Policy Rate, with reference to which money market operations would be conducted to target, so that the short term Hong Kong dollar inter-bank interest rates would not deviate significantly from it.** This Policy Rate would serve the functions of the Fed Funds Target Rate or the policy rates in other jurisdictions in which discretionary monetary management is practised. The Base Rate or the discount rate should then be priced against the Policy Rate.

74. Whether or not there should be reserve requirement in Hong Kong is a matter for consideration, having regard to whatever alternative monetary policy objective(s) determined. If and when such a need is identified and implemented, for example to exert influence over domestic credit creation, then **another new price tool could be a Reserve Requirement Ratio.** There is, of course, the related question as to whether required reserves are to be remunerated, noting that currently the Aggregate Balance does not attract any interest from the Exchange Fund. Again, this depends on the nature of the alternative monetary policy objective(s) determined. If bank reserves are to be remunerated, then there would be **two related, additional price tools for monetary policy – the interest rates paid by HKMA to banks on required reserves and excess reserves.**

75. Determining the strategies for discretionary monetary management is a delicate task. The professional discharge of this important task contributes much to the credibility of monetary policy. The usual central banking practice is for there to be a Monetary Policy Committee with experts from the central bank and from the private sector, functioning transparently, chaired by the governor of the central bank and served by both the research and market departments of the central bank. Almost by design, **the Currency Board Sub-Committee of the Exchange Fund Advisory Committee at the HKMA, now chaired by the Chief Executive of the HKMA can rather conveniently be transformed into such a Monetary Policy Committee.** The minutes of the Monetary Policy Committee should be published, as is now the case for the minutes of

the Currency Board Sub-Committee; and this should all be part of an overall communication strategy.

(5) *Loose End*

76. There is a loose end in Hong Kong's monetary system that needs to be tidied up, whether or not the LERS is to be retained. This concerns the **different convertibility arrangements for the different elements of the monetary base**. For the Aggregate Balance, the most important element, there are the formal Convertibility Undertakings, with the HKMA committed to buy US dollars at 7.75 and sell US dollars at 7.85. These were put in place in steps, starting in May 2005, as part of the three measures to strengthen the LERS in anticipation of the introduction of exchange rate flexibility to the renminbi, which occurred two months later in July 2005. For the Certificates of Indebtedness, the convertibility arrangement was in place right from the beginning when the LERS was established on 17 October 1983, specifying that they are to be issued and redeemed against US dollars at the fixed exchange rate of 7.80. For the \$10 currency note and variously denominated circulation coins and commemorative coins issued and redeemed by the HKMA through the Note Issuing Banks, there are no formal convertibility arrangements in place. When they are issued and redeemed, the clearing balance of the Note Issuing Banks are debited and credited respectively the equivalent Hong Kong dollar value. In effect, as they are transferrable into and out of the Aggregate Balance, they in practice enjoy the same Convertibility Undertakings as the Aggregate Balance. For the pool of Exchange Fund paper, the HKMA maintains US dollar assets enough to back it 100% at the exchange rate of 7.80, but they are operationally issued to and redeemed from the banks against Hong Kong dollar balances in their clearing accounts through, again, the HKMA debiting and crediting the equivalent Hong Kong dollar value. So, Exchange Fund paper in practice also enjoys the same Convertibility Undertakings applicable to the Aggregate Balance.

77. **Ideally, all elements of the monetary base should be subject to the same convertibility arrangements.** In terms of the maintenance of exchange rate stability, the most important ones are the Convertibility Undertakings for the Aggregate Balance, because that is where the large foreign exchange transactions are settled. When the single exchange rate at 7.80 that applies to the issue and redemption of Certificates of Indebtedness was introduced in October 1983, the Aggregate Balance, the crucial element of the monetary base, did not exist. **This difference in the convertibility arrangements, however, creates opportunities for profit or loss on the part of the Note Issuing Banks that is not shared by other banks.** If additional bank notes are issued at a time when the exchange rate is stronger (weaker) than 7.80, the Note Issuing Banks make a profit (loss) in the form of the exchange rate differential. As other banks obtain and return bank notes from and to the Note Issuing Banks against Hong Kong dollar value, they are not in a position of making similar profits or losses. As over time the demand for bank notes in circulation rises, the difference in convertibility arrangements provide a significant incentive for the Note Issuing Banks to keep the exchange rate on the strong side of 7.80. That incentive is greater ahead of the seasons

for the issue of large amounts of additional bank notes, notably the Lunar New Year. I should add, however, that there is no conclusive evidence that the Note Issuing Banks have been behaving in such a manner, although for quite a long time now, the exchange rate has been persistently on the strong side of 7.80. Any such profits made by the Note Issuing Banks would in fact be book losses incurred by the HKMA for the account of the Exchange Fund, in that it takes on US dollar assets that are worth less Hong Kong dollars than the corresponding liabilities in the form of the Certificates of Indebtedness at Hong Kong dollar face value.

78. This anomaly can very simply be removed by changing the practice of issuing and redeeming Certificates of Indebtedness. Instead of against US dollars at the fixed exchange rate of 7.80, they should be issued and redeemed against Hong Kong dollar value by the HKMA debiting and crediting respectively the Hong Kong dollar balances of the Note Issuing Banks. There will then be just one set of Convertibility Undertakings that applies to the Aggregate Balance, but since all other elements of the monetary base are transferrable with the Aggregate Balance, the whole of the monetary base is, in effect, subject to the same convertibility arrangements.

79. But I would not underestimate the possibly adverse psychological effect of such a change, although it is nothing more than a psychological effect that can be minimized through clear explanation. The 7.80 exchange rate for the issue and redemption of Certificates of Indebtedness has been there from the beginning, giving the clear impression that Hong Kong dollar bank notes are 100% backed by US dollars held at the Exchange Fund at the fixed exchange rate of 7.80. This will in effect continue to be the case after the change, and this will have to be emphasized, but technically the applicable exchange rate would become the market exchange rate, which, through the Convertibility Undertakings, will be kept at between 7.75 and 7.85. **In terms of delivering exchange rate stability through currency board arrangements, the tidying up makes no technical difference at all.** But it is also possible that the tidying up may be interpreted as a prelude to abandoning the LERS. Any change, however technical, will have that connotation. **But this change is a must if meaningful discretionary monetary management is to be introduced.**

VI. The Political Considerations

80. I am not a politician and I still do not know whether I should count this as a blessing. Over the years, watching the politically minded close up on how they behave, I have developed an allergy towards politics. Yet I am realistic enough to appreciate that political considerations matter, even in such technical subjects like shaping the monetary system or determining and operating monetary policy. With trepidation, I therefore attempt to address them here, in the hope that doing so would enhance the comprehensiveness of this technical paper. But there is a possibility, I must point out, that my political allergy might have compromised the objectivity of this section. So I shall at least try to be brief.

(1) *Decision Making*

81. As analyzed earlier in this paper, the existing legal framework seems, to me, to allow the types of modifications to Hong Kong's monetary system described in this paper to be made, should any of them be considered appropriate, without the need to introduce legislative amendments. This important point, of course, needs confirmation by lawyers. If, indeed, my interpretation of the legal position is correct, then clearly **the authority to make decisions on the future of the monetary system of Hong Kong is the Financial Secretary, exercising the powers given to him in the Exchange Fund Ordinance.**

82. The letter exchanged between the Financial Secretary and the Monetary Authority on 25 June 2003 articulated this position on record, as follows: **“the Financial Secretary shall be responsible for determining the monetary policy objective and the structure of the monetary system of Hong Kong. The Monetary Authority shall on his own be responsible for achieving the monetary policy objective, including determining the strategy, instrument and operational means for doing so, and for maintaining the stability and integrity of the monetary system of Hong Kong”**. In a related statement issued on 27 June 2003 by the Chief Executive of the Hong Kong Special Administrative Region concerning “Responsibilities of the Financial Secretary and the Secretary for Financial Services and the Treasury”, there is also clear confirmation of this position.

83. In exercising his powers of control over the Exchange Fund, the Financial Secretary has to consult **the Exchange Fund Advisory Committee**, established under Section 3(1) of the Ordinance. As the operation of the monetary system of Hong Kong involves arrangements between the banks and the HKMA and transactions for the account of the Exchange Fund, proposals for changing the monetary policy objective or to the structure of the monetary system are subject to consultation with the Exchange Fund Advisory Committee. The Financial Secretary will obviously listen to the professional views of **the Monetary Authority**, appointed by him under Section 5A of the Ordinance to assist him in the performance of his functions under the Ordinance, among other things. In any case, the Monetary Authority is a member of the Exchange Fund Advisory Committee.

84. Given the professional orientation of the HKMA, deliberately built up over the years through the setting up of the HKMA itself very much with that in mind, staffing it largely with professionals and providing the resources to undertake the necessary research and retain expertise there, and the rather more political orientation of the post of the Financial Secretary, initiatives for monetary reform will likely come from the HKMA. This would be in the form of **proposals from the Monetary Authority put to the Exchange Fund Advisory Committee with the consent of the Chairman of the Committee, the Financial Secretary.** This was the case in the past, when I was Chief Executive of the HKMA (the Monetary Authority as defined in the Exchange Fund Ordinance) from April 1993 to September 2009. But this depends very much on the personalities involved (principally the Financial Secretary and the Monetary Authority) and the chemistry of their relationship. It is, of course, **entirely proper for the Financial Secretary to form his own ideas on the monetary system and initiate discussions at the Exchange Fund Advisory Committee.**

85. But it would be unrealistic to conclude that the Financial Secretary and the Monetary Authority could between themselves determine the future of the monetary system of Hong Kong. The matter is of such importance to Hong Kong that any **Financial Secretary would seek guidance from the Chief Executive of the Hong Kong Special Administrative Region, who in turn would probably seek advice from the Executive Council and from Beijing,** given the implications for the stability and prosperity of Hong Kong, notwithstanding the clear autonomy in monetary affairs laid down in Article 110 of the Basic Law. Again, this depends very much on the mentality of the individuals concerned, but I would think that the probabilities of the Financial Secretary taking matters in his own hands as extremely low and the Chief Executive not consulting or informing Beijing as very low. And all consultations will need to be conducted confidentially, given that the subject is highly market sensitive.

86. **Thus there is a (larger than desirable) number of political dimensions from which the subject matter would be looked at, if ever there is a proposal for significant modifications or fundamental change.** However, one can safely assume that all concerned would have the public interest of Hong Kong prominently in their minds when addressing such a proposal, although there may be other considerations to take account of in each dimension. Hopefully, these other considerations would not be allowed to override the public interest of Hong Kong, but one can never be sure. And there will inevitably be differences of opinion, reflecting different assessments of the pros and cons involved, as seen from different perspectives. **More often than not, regrettably, without the pressures of a crisis that is either looming large or already ongoing, significant differences of opinion not resolved would result in the status quo being maintained. Reform of the monetary system in peaceful time takes leadership, foresight, courage and effective persuasion.**

87. There is also the close correlation between the downside risk of important policy changes going wrong by varying degrees on the one hand and the extent of damage to the political future of the responsible policy makers on the other. This, regrettably, is a political reality that has an increasingly strong bearing on public policy decision making

in Hong Kong – very much a reflection of the peculiar political environment of Hong Kong. I doubt very much, for example, whether the introduction of the “Accounting Arrangements” in 1988 and the intervention in the stock market in 1998 would be undertaken in the political environment of today, other things being equal. It is entirely understandable, therefore, that, in the current political environment, **the best option to some (personally) may be to avoid making (personally) risky decisions by conveniently arguing for the maintenance of the status quo**, given its sterling track record. But I much prefer that such a conclusion, or indeed any other conclusion on the future of the monetary system of Hong Kong, is the result of informed discussion instead.

88. I do not know whether there is such informed discussion going on in respect of the future of the monetary system of Hong Kong, and, if so, where it is taking place. I encourage it and obviously happy to offer my views, as I do now through the publication of this paper. **It is, of course, not easy to come to any authoritative conclusion, generally on whether there is meaningful scope for the monetary system to serve the public interest better and specifically the changes necessary to create that scope and how to exploit it.** To some, there is no urgency in these matters, given the lack of evidence on the risks of maintaining the status quo and the unknown risks of change, however minor the change may be. To others, prevention is always better than cure, if indeed there is concern over the long term sustainability of the existing system. I certainly hope that there is no lack of leadership, foresight, courage and power of persuasion, supported by professional expertise, in the Hong Kong Special Administrative Region Government, old or new, to tackle difficult monetary issues in the public interest, no matter how technical and sensitive they may be.

(2) *Fiscal and Monetary Discipline*

89. I should also point out two crucial determinants on the sustainability of any monetary system, in the light of international experience. For an economy as externally oriented and free as Hong Kong, these determinants are of much greater significance than in other jurisdictions, requiring much greater care. First is the political willingness to pursue prudent macroeconomic policies, in particular to observe fiscal discipline. Frankly, I have worries here. While the monetary system of the United States can survive a deficit to GDP ratio of 10% and a debt to GDP ratio of 100% (although there is now serious doubt in the case of the euro zone), much lower corresponding numbers would be death warrants for the monetary system of Hong Kong. Let me stick my neck out further to drive home the point. Democracy (民主), public opinion (民意) and public standing (民望) are all very important to effective governance and are political attributes that politicians and even public officers crave for. And I applaud those who can achieve high scores in these attributes. But these attributes, when expressed in Chinese, are all just one word away from, or 50% into, populism (民粹). **I hope Hong Kong does not go down that slippery slope towards large government, persistent budget deficits, heavy public debt, financial meltdown and monetary crisis.**

90. At a time when the government is running a substantial budget surplus and holding a large amount of fiscal reserves, these worries seem unjustified. But the highly externally oriented nature of Hong Kong is such that our economic fortunes can turn very quickly. **The structure of the public finances of Hong Kong also now suffers from the lack of a theoretically sound foundation** that lays down requirements or guidelines, for example, to limit the vulnerability of the general revenue to volatility in macroeconomic performance or to ensure that there is a surplus in the recurrent account large enough to cover a significant part of capital expenditure, in view of the unreliable nature of capital revenue. Instead, we have the rather worrying practice of unprincipled frittering away of tax payers money that could otherwise be spent more productively elsewhere or not collected in the first place, through lowering tax rates rather than granting one-off concessions year after year. The practice also raised unreasonable expectations of those who benefited for a year or two and, with the encouragement of politicians, demanded ever increasing amounts. The lack of a theoretical foundation for our public finances has also made it difficult for our fiscal authorities to hold their grounds on whatever well intended budgetary proposals when challenged, further damaging their credibility.

91. Consequently, there have been suggestions for imposing stricter discipline on the public finances of Hong Kong through quantifying the requirement in Article 107 of the Basic Law for the Hong Kong Special Administrative Region to “follow the principle of keeping expenditures within the limits of revenues in drawing up its budget” and defining how to “keep the budget commensurate with the growth rate of its gross domestic product”, and have these enshrined in law, for example, in the Public Finance Ordinance. **This seems worth pursuing, as a risk management measure to prevent the unfavorable political environment from further eroding fiscal prudence. Furthermore, if there is to be a move from a rule-based to a discretion-based monetary system in order better to serve the public interest, which could be (erroneously) seen as involving an erosion of monetary discipline, stricter fiscal discipline will help the establishment of credibility and confidence.**

(3) *Independence for the HKMA*

92. **The second determinant crucial to the sustainability of a monetary system encompasses the credibility, professionalism and independence of the HKMA.** This is the reason why I defended these attributes vehemently when I was in office; and I very much hope my successors will do the same and perhaps even more effectively, with the benefit of the administrative safeguards that have been put in place over the years. The Financial Secretary also needs to respect them and, in exercising his power of appointment over the senior staff at the HKMA, particularly the Monetary Authority, refrain from being influenced by political considerations or pressure. That is why he has committed himself to seeking advice from the Governance Sub-Committee of the Exchange Fund Advisory Committee, although it is still up to him to decide on whether or not to act in accordance with that advice.

93. The HKMA is also given operational independence in that “the Monetary Authority shall on his own be responsible for achieving the monetary policy objective ...” Furthermore, the letter exchanged on 25 June 2003 specified that: “**if the Financial Secretary has chosen to override the Monetary Authority by giving him instructions, or has himself exercised those powers delegated to the Monetary Authority, the Financial Secretary shall disclose publicly why he has chosen to do so**, unless he considers, after consultation with the Monetary Authority, that such disclosure is prejudicial to the stability and integrity of the monetary and financial systems of Hong Kong. Such disclosure shall be made within three months of the giving of such instructions or the exercising of such powers delegated to the Monetary Authority”.

94. There are always limitations to administrative safeguards, although, with a rule-based monetary system, what we now have in Hong Kong are adequate and my experience is that they have worked well since they were put in place in 2003. **The important questions here are, of course, whether or not there is a need for additional safeguards if the monetary system becomes one that involves discretionary monetary management and, if so, what form they should take.** I have little doubt that there will be strong temptation for political interference, for example, in the determination of interest rates by the HKMA if the monetary system were to involve discretionary monetary management, even though the letter exchanged in June 2003 gives independence to the HKMA in performing such a task. I shall not rehearse the well known downside risks of political interference in monetary management or the established practices in other jurisdictions to safeguard independence of their central banks. I shall just emphasize here the desirability of additional safeguards in Hong Kong if there is to be any shift into discretionary monetary management. In the fullness of time, a proper piece of legislation defining the mandate, governance and accountability of the HKMA may not be a bad idea.

(4) *Psychology of “One Country, Two Currencies”*

95. There is something about how exchange rates are numerically expressed that I have long chosen not to believe in and simply dismiss as purely psychological, and this is **the notion that one currency is “bigger” than another if one unit of it can be exchanged for more than one unit of the other.** The exchange rates of sterling, the euro and a number of currencies are expressed in foreign exchange markets as the number of US dollars per unit of those currencies, but the exchange rates of most other currencies are expressed as the number of units of those currencies per US dollar. There does not seem to be any move towards standardization. Perhaps there is no need, given the ease of finding the reciprocal of any number. And the desire of individual jurisdictions for its currency to serve as the “numeraire” of world currencies, which carries the connotation of being the reserve currency of the world, is understandable. But, I thought, in the final analysis, it is the robustness of the economy that matters and not whether the number is bigger or small than one. By extension, therefore, I have also dismissed the notion that the people of the jurisdiction with the bigger currency can justifiably feel superior to the people of the jurisdiction with the smaller currency. In this

connection, I have felt that the near slogan of the US Treasury that it pursues a strong dollar policy, given the large current account deficit that the US is running as somewhat meaningless.

96. Ever since the re-introduction of flexibility to the exchange rate of the renminbi in July 2005, and seeing the subsequent, almost continuous appreciation of the renminbi against the US dollar and therefore the Hong Kong dollar, I have been hearing interesting comments from the people of Hong Kong and our brethren north of the border on what can be described as the “reversal of superiority”. There was even a sense of despair among some of my Hong Kong friends, particularly those who make frequent spending trips up north, when the exchange rate of the renminbi against the Hong Kong dollar fell below one at the end of 2006. **There was growing concern about “the renminbi premium” getting bigger all the time, leading to Mainland people psychologically “belittling the value of Hong Kong people’s money” and thus “eroding the respect of the Hong Kong people when they are on the Mainland”.** As a rational person I do not quite share these views, but, having spent more time on the Mainland since retirement and come into contact more with the general public, I have come around to realizing the extent of the impact of the appreciating exchange rate of the renminbi against the Hong Kong dollar on the psychology of the people. This psychology, reinforced by the rise of Mainland consumerism that is being manifested in Hong Kong in ways that some have found irksome, may have, I fear, contributed to eroding somewhat the harmonious relationship between the people of Hong Kong and of the Mainland.

97. But I am not in a position to analyze the importance of this to the future of the monetary system of Hong Kong, other than to point out, to our political leaders, that **there may be significant added psychological value to the stabilization of the exchange rate between the renminbi and the Hong Kong dollar, not to mention a catching up in the number itself.**

VII. Conclusion

98. The monetary system of Hong Kong, characterized by the Linked Exchange Rate System, has served Hong Kong well for almost thirty years. However, a fixed exchange rate cannot be an end in itself, although it can be an effective tool for achieving a monetary environment that serves well the public interest. With the changing external environment, the need to maintain the status of Hong Kong as an international financial centre in accordance with the requirement of the Basic Law and the changing aspirations of the people of Hong Kong, there is a need to address the questions as to whether the monetary system of Hong Kong, as currently structured, can continue to serve the public interest of Hong Kong in the best possible manner, and if not what modifications should be introduced so that it can.

99. Subject to confirmation by legal experts, the legal framework on which the monetary system is based, and monetary policy determined, allows the adoption of traditional central banking practices of exercising discretionary monetary management to achieve traditional monetary policy objectives. Monetary reform measures have also discreetly been introduced over the years to put the Hong Kong Monetary Authority in as effective a position as any central bank to control the supply and the price of the domestic monetary base – a technical capability essential to the exercising of discretionary monetary management. Supported by necessary monetary research on, for example, the policy transmission mechanism, safeguards on the independence of the Hong Kong Monetary Authority akin to those of central banks in other jurisdictions, and transparent arrangements for policy making and governance, the prospects of quickly establishing policy and institutional credibility are good.

100. Separately, the long term sustainability of the status of Hong Kong as an international financial centre and the continued maintenance of monetary and financial stability in Hong Kong require a monetary system that allows currency risks to be managed by overseas investors and fund raisers using the financial markets of Hong Kong through providing a financial infrastructure that allows transactions to be conducted in a currency of their choice. It is unrealistic to expect the monetary system of a jurisdiction with seven million people, if it keeps its domestic orientation, with the domestic currency continuing predominantly to perform the roles of money, to continue meaningfully as an international financial centre to serve the needs of international financial intermediation between a jurisdiction with 1.3 billion people and the rest of the world, and maintain monetary and financial stability at the same time.

101. Technically, whether or not fundamental changes are introduced to the monetary system of Hong Kong so that it serves better the public interest, it will be desirable, in any case, to unify the two different Convertibility Undertakings for the two elements of the monetary base, namely, the bank notes in circulation and the Aggregate Balance. And if the decision is taken to make room for discretionary monetary management and accept exchange rate flexibility, with well defined monetary policy objectives, the Convertibility Zone could be meaningfully widened (in one go or by steps) or simply removed, or be turned into a corridor for the exchange rate (against the US dollar or the

renminbi or an undisclosed basket of currencies), with the width, the slope and the centre of the corridor subject to periodic review. It is also possible to do away with an exchange rate target or zone, and focus in managing the domestic monetary conditions in order to achieve the defined monetary policy objectives.

102. The political considerations are, nevertheless, complex; but hopefully all involved would be guided by what is in the best interest of Hong Kong.

103. I have not consulted anybody in the writing of this paper. So, mistakes, inaccuracies, misguided views, etc, are all my responsibility. I also offer my apologies to those who may be upset by my, sometimes rather too frank, views.

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