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The Future of the Monetary System of Hong Kong

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Money and Monetary Policy

The Roles of Money

- Medium of exchange
- Store of wealth
- Unit of accounting

Monetary Policy

- Traditional focus is in ensuring currency stability, understandably to allow money to perform its various roles effectively; many jurisdictions adopt single monetary policy objective of currency stability, defined as low inflation rate
- Multiple objectives increasingly being pursued given that the availability and price of money affect different aspects of the economy, e.g. growth, employment, external balance, and achieving them is in the public interest

The Monetary System

- A system that ensures currency stability so that domestic money performs its roles effectively and that enables monetary policy controlling the availability and price of money is exercised in a manner that serves the best public interest
- Exclusive domestic orientation with little attention to possible international role of domestic money
- Uniqueness of the monetary system of an international financial centre with its own currency
- “One country, two currencies” in China and “Many countries, one currency” in Europe

The Monetary System of Hong Kong Chronological History

- 1842 – 1863: Spanish, Mexican and other silver dollars, the Indian rupee and Chinese cash proclaimed legal tender in Hong Kong in March 1842; a commercial bank started to issue Hong Kong dollar bank notes in 1845
- 1863 – 1935: Silver Standard
- 1935 – 1972: Sterling Standard
- 1972 – 1974: US dollar peg
- 1974 – 1983: Floating exchange rate
- From 1983: Linked Exchange Rate System

The Monetary System of Hong Kong
History of Money

- Hong Kong dollar is legal tender in Hong Kong from 1935
- Not illegal to circulate foreign currencies in Hong Kong; law to prohibit circulation of foreign currencies repealed in the mid-eighties as part of a contingency plan to allow dollarization in case Linked Exchange Rate System did not work well
- Foreign currencies can perform the roles of money in Hong Kong if parties to the transaction agrees to their use, but they are not legal tender in the sense that the recipient must accept them in payment

The Monetary System of Hong Kong
History of Monetary Policy

- Other than in the period 1974-1983, monetary policy "objective" is exchange rate stability
- Arguably a realistic objective for a highly externally oriented economy; trade in goods currently three times GDP
- 1983 monetary crisis drew sharp focus on exchange rate; 15% depreciation in 1½ trading days at the height of crisis in September 1983
- Fixed exchange rate (against what?) should not necessarily be an end in itself; monetary policy to serve the public interest

The Monetary System of Hong Kong
History of Monetary Control

- For monetary policy, aimed at achieving whatever objective(s), to be effective, the authorities must have control over the supply and/or price of money, more precisely base money (variously referred to as the monetary base, reserve balance or clearing balance of the banking system)
- Up until 1988, power of control of the monetary base in the commercial bank (HSBC) serving as the Clearing Bank of the banking system
- Indirect control of the monetary base established only in 1988 through the "Accounting Arrangements"

The Monetary System of Hong Kong
History of Monetary Control

- Direct control of monetary base established only in 1996 on the occasion of the introduction of Real Time Gross Settlement (RTGS) system when all banks were required to maintain clearing account with the HKMA
- The foundation of a proper monetary system was thus discreetly and successfully laid
- Rule based control versus discretion based control of monetary base

The Monetary System of Hong Kong
History of Monetary Control

- Hong Kong's monetary rule: initially only involved the issue and redemption of bank notes against US dollar at exchange rate of HK$7.80 to US$1
- After full control of monetary base is established, monetary rule gradually modified to include, crucially, "practices" on the expansion and contraction of clearing balance of banking system against US dollar (unsterilized foreign exchange intervention)

The Monetary System of Hong Kong
History of Monetary Control

- 2003 Exchange of Letter between the Financial Secretary and the Monetary Authority
- Monetary policy objective: "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"
- Structure of 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"

The Monetary System of Hong Kong
History of Monetary Control

- Appropriateness of fixed exchange rate and of the anchor currency often questioned, presenting challenges to expectation management
- Hong Kong's dependence on economy of the Mainland of China becoming much higher than its dependence on US economy in 1983; should currency anchor be RMB instead; sharp capital inflow along with expectation of RMB appreciation in 2004-2005; ballooning of monetary base
- Formalization of "practices" in the expansion and contraction of clearing balance in May 2005 into Convertibility Undertakings (buy US$ at 7.75 and sell US$ at 7.85); capital inflow stabilized
- Re-introduction of flexibility of exchange rate for the RMB in July 2005 had no effect on Hong Kong dollar

The Monetary System of Hong Kong Questions for the Future

- What are in the best public interest as far as the monetary system is concerned?
- Is it desirable to shift from rule based monetary control to discretion based monetary control?
- What alternative monetary policy objective(s) should be pursued?
- What lessons can be drawn from practices in the rest of the world?
- What should be the attitude of the authorities?

The Monetary System of Hong Kong
Questions for the Future

- Is a shift from rule based to discretion based monetary control legally possible without legislative changes?
- What monetary system best supports Hong Kong's role as an international financial centre and ensures effective achievement of monetary policy objective(s) in Hong Kong?
- Does HKMA have the technical and professional ability to deliver alternatives?
- What are the political considerations?

The Legal Framework

- National Law: The Basic Law of the Hong Kong Special Administrative Region of the People’s Republic of China (adopted on 4 April 1990 by the Seventh National People’s Congress of the People’s Republic of China at its Third Session)
- Local Law:
  - The Exchange Fund Ordinance
  - The Legal Tender Notes Issue Ordinance

Legal Framework
Issues for Discussion

(1) Legal tender

(2) Issue of Hong Kong currency

(3) Convertibility

(4) Power of control over the monetary base

(5) Monetary policy objective

(6) Central banking law

Legal Issues – (1) Legal Tender

- Article 111 of Basic Law: The Hong Kong dollar, as the legal tender in the Hong Kong Special Administrative Region, shall continue to circulate
- The monetary system of Hong Kong, at least until 2047, will always feature the Hong Kong dollar as the legal tender
- No law in Hong Kong to prohibit the use or circulation of foreign currencies
- Legal framework of monetary system does not undermine the freedom to choose on the currency to be used for performing the basic functions of money in Hong Kong
- RMB can play a more significant role in Hong Kong, if the users prefer

Legal Issues – (2) Issue of Hong Kong Currency

- Article 111 of Basic Law: The issue of Hong Kong currency must be backed by a 100 per cent reserve fund
- Not a typical requirement in other jurisdictions
- Basic Law does not say in which currency the assets in the reserve fund backing the issue of Hong Kong currency should be denominated
- Does not preclude the holding of Hong Kong dollar assets in the reserve fund backing the issue of Hong Kong currency (defining this widely to include the Clearing Balance of banks)
- For example, discretionary "quantitative easing" through buying domestic assets legally possible

Legal Issues – (2) Issue of Hong Kong Currency

- Exchange Fund Ordinance: 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 …
- 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 the authority to issue and redeem Hong Kong dollar bank notes, can be done against Hong Kong dollars instead

Legal Issues – (3) Convertibility

- Article 112 of Basic Law: No foreign exchange control policies shall be applied in the Hong Kong Special Administrative Region. The Hong Kong dollar shall be freely convertible
- This may have the effect of constraining the ability of the HKSARG to adopt measures that are now becoming much better accepted internationally in dealing with volatile capital and destabilizing capital flows
- 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

Legal Issues – (4) Power of Control over the Monetary Base

- 1995 amendment to the Exchange Fund Ordinance requires authorized institutions (principally licensed banks) to maintain clearing accounts with the HKMA for the account of the Exchange Fund
- Crucial element of the monetary base on the balance sheet of the HKMA (for the account of the Exchange Fund)
- This and other provisions in the Exchange Fund Ordinance give effective powers of control over the monetary base to the HKMA, a necessary condition for any monetary policy objective to be achieved
- In exercising those powers of control over the monetary base, the HKMA can do so either in a non-discretionary manner or in a discretionary manner, depending on monetary policy objective specified by the Financial Secretary

Legal Issues – (5) Monetary Policy Objective

- Exchange Fund Ordinance: The Exchange Fund … shall be used 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
- "The exchange value of the currency of Hong Kong" not defined
- External exchange value: against a foreign currency (US dollar or RMB) or a basket of foreign currencies
- Internal exchange value: against a basket of goods and services in Hong Kong; such internal exchange value can be measured by the Consumer Price Index
- Legitimate use of powers under Exchange Fund Ordinance to achieve alternative monetary policy objective of low inflation

Legal Issues – (5) Monetary Policy Objective

- Article 113 of Basic Law: The Exchange Fund … shall be managed and controlled … primarily for regulating the exchange value of the Hong Kong dollar
- But Chinese versions of Basic Law and Exchange Fund Ordinance use respectively “港元汇价” and “港币汇价”, meaning the exchange rate
- External orientation of Hong Kong economy is such 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
- Exchange rate stability can only be maintained in the long run through the adoption of prudent macroeconomic policies, including the maintenance of price stability (“indirect” use of Exchange Fund and “incidental thereto” provision)

Legal Issues – (6) Central Banking Law

- Legal framework of the monetary system peculiar, but it works even if there are to be different monetary policy objective(s) determined by the Financial Secretary
- But desirable in the fullness of time for the existing legal framework to be replaced by a more traditional central banking law

Monetary Considerations

(1) Hong Kong dollar's role as domestic money in Hong Kong under "one country, two systems"

(2) Hong Kong dollar's role in organizing international financial activities in Hong Kong, as an international financial centre mandated in the Basic Law

(3) A multi-currency financial infrastructure

(4) Monetary freedom to pursue the public interest

Monetary Considerations – (1) Domestic Money

- Hong Kong is probably unique in that, notwithstanding not being a sovereign state, it has its own currency
- Strong public confidence in the Hong Kong dollar, which has a long history of stable external value
- Outlook of the anchor currency doubtful
- Shift of Hong Kong’s economic dependence: much more on Mainland of China now than on the US in 1983 when exchange rate to USD was fixed
- Increasing acceptance of RMB, which is on a clear appreciating trend
- Appropriateness of monetary policy increasingly questioned: currently engaging in involuntary quantitative easing and zero interest rates at a time when inflation rate is near 5%

Monetary Considerations – (2) Hong Kong Dollar's Role as International Money?

- Article 109 of Basic Law: The Government of the Hong Kong Special Administrative Region shall provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre
- An international financial centre is a place where financial intermediation takes place on an international dimension, matching the risk appetites of investors with the risk profiles of fund raisers; realistically this means providing a platform for Mainland investors and fund raisers to meet with overseas fund raisers and investors respectively
- Success measured by the volume of such financial intermediation being organized in Hong Kong, including turnover in secondary markets that provide the liquidity necessary to attract the primary market activities such as IPOs

Monetary Considerations – (2) Hong Kong Dollar’s Role as International Money?

- Is the Hong Kong dollar the choice currency to play the relevant roles of money (medium of transaction and store of wealth) in respect of international financial intermediation between the Mainland of China and the rest of the world?
- Foreign investors and fund raisers do not have a meaningful choice; but feel comfortable hitherto given that the Hong Kong dollar is de facto an extension of the US dollar; currency risk, considered incidental now, may become a concern
- Concern may eventually limit the utility of Hong Kong’s financial markets to foreign investors and fund raisers

Monetary Considerations – (2) Hong Kong Dollar's Role as International Money?

- Conduct of international financial activity in Hong Kong involves large flow of capital in and out of the Hong Kong dollar and credit creation in the Hong Kong dollar money market; look at IPO money as % of GDP
- Implications of the increasingly large presence of foreign owned, agile money denominated in Hong Kong dollars for monetary and financial stability in Hong Kong; 1997-98 experience
- International financial activities becoming increasingly complex, involving the use of leverage and derivatives
- Risk of international financial activities overwhelming the domestic financial activities that serve the rather small Hong Kong economy; risk needs to be managed

Monetary Considerations – (2) Hong Kong Dollar's Role as International Money?

- Important question: 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?

Monetary Considerations – (3) A Multi-Currency Financial Infrastructure

- A multi-currency financial infrastructure to give investors and fund raisers a choice in currency denomination and a chance to manage currency risks; their preference could well be to transact in USD or RMB
- Would enhance the ability of the authorities to maintain monetary and financial stability and safeguard the wider public interest
- Progress at the inter-bank level: Real Time Gross Settlement (RTGS) payment systems for HKD (1996), USD (2000), euro (2003) and RMB (2007)

Monetary Considerations – (3) A Multi-Currency Financial Infrastructure

- Progress at the retail, non-bank level painfully slow
- Reasons:
  - Lack of market demand to use foreign currencies
  - Response to experiment (RMB IPO) subdued
  - Support from intermediaries lukewarm
  - Inertia and vested interest
  - Strong sense of comfort (hopefully not false sense of security), on monetary stability in Hong Kong
- Strategic move is urgent; create critical mass to preempt marginalization as financial liberalization progresses on the Mainland

Monetary Considerations – (4) Monetary Freedom

- Desirable for that part of the monetary system of Hong Kong featuring the domestic currency – the Hong Kong dollar – playing the roles of money to become more domestically oriented
- With risks to domestic monetary stability suitably managed, the scope for pursuing alternative monetary policy objectives, if any, that possibly better serve the public interest will correspondingly be increased
- Hong Kong can thus afford greater monetary freedom
- Monetary reform need not always be crisis driven

Technical Considerations

(1) Effectiveness of monetary control

(2) Form of control

(3) Degrees of monetary freedom

(4) Control mechanism

(5) Loose end

Technical Considerations – (1) Effectiveness of Monetary Control

- Linked Exchange Rate system introduced in 1983 only established control over the banknotes element of the monetary base
- 1988 “Accounting Arrangements” established indirect control over the crucial element of the monetary base – the clearing balance of the banking system or the Aggregate Balance
- Full control established in 1996 when all banks were required to clear with HKMA for the account of the Exchange Fund
- HKMA in a position to control the supply and/or price of base money as effectively as any other jurisdiction

Technical Considerations – (2) Form of Control

- Currently rule based, non-discretionary control over the Aggregate Balance in the form of the Convertibility Undertakings (buying USD at 7.75 and selling at 7.85)
- Clear alternative is discretionary control, with flexibility in timing, frequency and orientation (supply or price of base money) of money market operations to address policy preoccupations at the time
- HKMA is well positioned to exercise discretionary monetary management if it is called upon to do so
- Need to deepen understanding of relationship between the supply and price of base money with economic variables which make up the alternative monetary policy objectives

Technical Considerations – (3) Degrees of Monetary Freedom

- Within the current Convertibility Zone of 1,000 pips of the exchange rate (7.75 to 7.85), the HKMA has the freedom to conduct foreign exchange and money market operations
- Convertibility Zone may be too small for meaningful discretionary money market operations, which could also be misinterpreted as prelude to regime change
- HKMA did act to reduce size of Aggregate Balance, when exchange rate was within the Convertibility Zone, presumably to limit its effects on credit creation, inflation and eventually exchange rate stability
- Worth experimenting for the future

Technical Considerations – (3) Degrees of Monetary Freedom

Alternatives:

- Significantly widening the Convertibility Zone
- Have it move in a particular direction along with time, with HKMA periodically determining the centre, the slope and the width of the Zone, akin to Singaporean system
- Zone can be redefined against another anchor currency or a currency basket
- Replacing Convertibility Undertakings by indicative band width for the exchange rate to be maintained by discretionary exchange market intervention
- Withdraw Convertibility Undertakings altogether and simply conduct market operations to achieve alternative monetary policy objectives

Technical Considerations – (4) Control Mechanism

- Instruments for open market operations already exist in the form of Exchange Fund Bills and Notes; HKMA can also buy and sell other assets, including foreign exchange
- Discount window and discount rate already exist
- May need to introduce a new Policy Rate as target for money market operations
- Additional tools can be introduced – Reserve Requirement Ratio, interest rate on reserves, interest rate on excess reserves
- Currency Board Sub-Committee of Exchange Fund Advisory Committee could conveniently be turned into a Monetary Policy Committee

Technical Considerations – (5) Loose End

- Currently different Convertibility Undertakings for different elements of the monetary base
- Certificates of Indebtedness backing the issue of bank notes by three commercial banks – issued and redeemed against USD at 7.80
- Aggregate Balance – buy USD at 7.75 and sell USD at 7.85
- Exchange Fund paper – transferrable with Aggregate Balance and therefore enjoy the same Convertibility Undertakings as Aggregate Balance
- Difference presents opportunities for Note Issuing Banks to make profits or losses not shared by other commercial banks
- Needs tidying up, possibly through the issue and redemption of Certificates of Indebtedness against the clearing balances of the Note Issuing Banks
- Tidying up necessary for moving onto discretionary monetary management

Political Considerations

- Politics of decision making in Hong Kong
- Fiscal and monetary discipline, and the risks of populism
- Independence of the HKMA
- Psychology of "one country, two currencies"

Conclusion

- Linked Exchange Rate system served Hong Kong well for almost 30 years, but fixed exchange rate cannot be an end in itself
- Important to be satisfied that the monetary system serves the public interest in the best manner possible, considering also the need to maintain Hong Kong as an international financial centre
- If considered appropriate, the alternative may be to engage in discretionary monetary management to achieve objectives that are in the public interest and there are workable alternatives
- With monetary reform discreetly introduced in the past, the legal, monetary and technical frameworks are there to support change, if change is considered desirable; but the politics is unpredictable

The Future of the Monetary System of Hong Kong

Sir Winston Churchill, 28 September 1949:

> "There is no sphere of human thought in which it is easier for a man to show superficial cleverness and the appearances of superior wisdom than in discussing questions of currency and exchange."