



## The remarkable resilience of Hong Kong's exchange rate regime

In 1983, Hong Kong pegged its currency to the US dollar. Since then, the special administrative region (SAR) has undergone profound transformations, changing from an industrial economy cut off from its Chinese hinterland to a key gateway for goods and capital between China and the rest of the world, and then to a centre for high value-added services, without abandoning the peg. The latter has also withstood various episodes of tension (Asian and 2008 financial crises, 2019 Protests, Covid).

The history and functioning of this linked exchange rate regime sheds light on the factors of its resilience, as well as on the challenges that lie ahead. Hong Kong remains a key link in China's international financial integration, which should lead to maintaining the peg.

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G15

**180%**

foreign exchange reserve coverage  
of the monetary base in Hong Kong at end 2021

**85%**

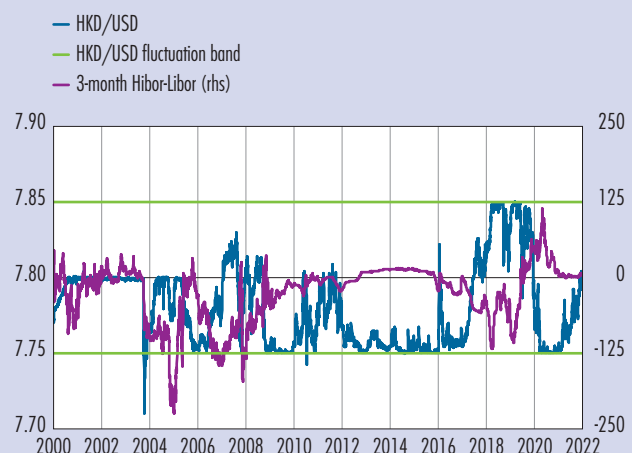
the share of equity purchases in China by foreigners  
that were channelled through Hong Kong between 2016  
and end 2021

**1<sup>st</sup>**

Hong Kong's share of global IPOs in 2019

### HKD/USD exchange rate and interbank spread

(level; basis points)



Source: CEIC.

Note: HKD, Hong Kong dollars; USD, US dollars; Hibor, Hong Kong interbank offered rate; Libor, London interbank offered rate.



### 1 Hong Kong's currency board is a credible system

#### The system has adapted to the macroeconomic developments of recent decades

The Hong Kong dollar (HKD), which had been pegged to the pound sterling since 1935 (see Box 1), experienced a break in August 1971, when the US administration decided to suspend the convertibility of the dollar (USD) into gold and the British government was forced to float the pound sterling. The currency was then briefly pegged to the US dollar, first at a rate of HKD 5.65 to the USD and then, from February 1973, at HKD 5.085. But in November 1974, against a weakening of the US dollar, the Hong Kong dollar began to float freely. In the absence of a clear monetary policy objective, this exchange rate regime failed to anchor inflation, which reached 15.8% in 1980 (Hong Kong Monetary Authority – HKMA, 2000). The Hong Kong dollar depreciated rapidly from HKD 5.13 to the USD in 1981 to HKD 9.60 in 1983. This was compounded by speculative attacks and an escalating crisis of confidence over Hong Kong's future. The latter reached its peak in 1983, due to the uncertainty surrounding the Sino-British negotiations that led to the signing of the Joint Declaration in 1984. On 15 October 1983, the SAR government, faced with both currency instability and doubts about the soundness of a number of banks that carried a high exchange rate risk, announced a new exchange rate regime, which is now the basis of Hong Kong's monetary system: the link between the Hong Kong dollar and the US dollar at a fixed rate of HKD 7.80 to the USD, guaranteed by a currency board (see Box 2).

In addition, in parallel with the evolution of the Hong Kong dollar's peg, the missions of the Exchange Fund (see Box 1) were broadened and the government's reserves were entrusted to it in the 1970s. It was then integrated into the Hong Kong Monetary Authority (HKMA), which was created in 1993. The fact that a monetary authority now manages the foreign exchange reserves rather than an "exchange fund" is clearly a sign that the rules have been eased over time.

Over the last four decades, the system has thus undergone a number of changes, enabling it to adapt to the changing macroeconomic environment, without calling into question its fundamental principles. Thanks to these adaptations, the system, which is now known as the Linked Exchange Rate System (LERS), is more flexible, but remains organised by rules and governed by the principles of the currency board (CB).

#### The system has proved its resilience in the face of crises and dollar fluctuations

Since 1983, the fixed exchange rate system and the parity vis-à-vis the dollar have withstood a variety of changes. First, political changes, with the conclusion of the Sino-British negotiations, the return to Chinese sovereignty in 1997 and the gradual tightening of China's control which has gathered pace since 2019. Then economic changes, as the SAR went from being an industrial and trading economy cut off from its Chinese hinterland to a key gateway for goods and capital between China and the rest of the world. Hong Kong has now become a centre for high value-added services, particularly financial services, competing with the Chinese cities of Shenzhen and especially Shanghai, but also with Singapore, London and New York. The financial centre itself has reflected these structural changes, gradually becoming essentially a place for listing Chinese companies. Finally, macroeconomic obstacles with long phases of desynchronisation of the US and Hong Kong economic cycles. This has made the peg to the US dollar procyclical, with in particular consequences for property prices, forcing the SAR to be a pioneer in macroprudential policy. The peg has also weathered the wide fluctuations both in the dollar and in US monetary policy. Finally, it withstood the Asian crisis of 1997, the strength of the peg having resisted speculation, and then the SARS crisis in 2003, the great financial crisis of 2008 and the Covid-19 pandemic.

The HKMA's objective remains monetary stability through an external anchor. This monetary stability is now defined as a stable exchange rate for the Hong Kong dollar against the US dollar, within a band of HKD 7.75 to



### BOX 1

#### An overview of Hong Kong's history

Hong Kong's history is several thousand years old. However, the city experienced spectacular growth from the second half of the 19th century onwards, when it came under British rule. The colony gradually expanded from Hong Kong Island, under the Treaty of Nanjing in 1842, to the current territory of the Special Administrative Region (SAR), established by the Convention for the Extension of Hong Kong Territory signed in 1898 between the United Kingdom and the Empire of China. In 1842, at the end of the first Opium War, the city counted 6,000 inhabitants. Its population grew steadily from then on, rising to 120,000 at the time of the second Opium War (1862), and now stands at over seven million.

British victories, securing in particular access to the Chinese market, enabled the United Kingdom to use Hong Kong as a major port for its trade in the region and beyond throughout the whole Empire. Thus, in the 1900s, its maritime activity exceeded that of New York or Amsterdam. Even though the Communist Party's takeover in 1949 gradually closed the Chinese market again, cutting Hong Kong off from its Chinese hinterland, the port, and more generally the Hong Kong market, remained the most important trading post in South East Asia. The reopening of China and the ensuing period of exceptional growth that gained momentum under Deng Xiaoping, together with Hong Kong's retrocession to China, offered new opportunities.

With the development of trade, the need for monetary stability and a widely-accepted exchange currency was felt. At the time of the Treaty of Nanking, many currencies were in circulation on the island: silver rupees, Mexican dollars, Chinese taels, etc. In 1845, the Oriental Bank Corporation issued banknotes denominated in silver dollars, which was then almost an international currency, indexed to the price of silver, and in 1863 the same silver dollar became the legal tender. In 1866, the government began issuing a local version, and the silver standard became the basis of the monetary system until 1935, when the government announced that the Hong Kong dollar would be pegged to the pound sterling at a rate of HKD 16 to the pound.

In 1935, the Exchange Fund was set up and entrusted with the task of managing official reserves and providing the necessary support to safeguard the exchange value of the Hong Kong dollar. Under the Currency Ordinance of 1935, the issuing banks (Mercantile Bank of India, Chartered Bank of India, Australia and China and Hong Kong and Shanghai Banking Corporation) were required to surrender to the Exchange Fund all silver bullion held by them against their banknote issues in exchange for certificates of indebtedness. These certificates were the legal backing for the banknotes issued by the authorised banks under what became, in effect, a currency board system (see Box 2) similar to those existing elsewhere in the British Empire.

HKD 7.85 to the US dollar, which was established in 2005 to provide some flexibility to the system. Under the LERS, foreign exchange intervention to bring the Hong Kong dollar back into its convertibility zone is an automatic process, through the triggering of convertibility undertakings (CUs). Within the zone (i.e. when the exchange rate is between HKD 7.75 and HKD 7.85 to

the USD), the HKMA is free to intervene at its discretion. Under the LERS, it is thus primarily the interest rates on the Hong Kong dollar that are adjusted. The volatility of short-term interest rates on the local currency is often viewed as a drawback of currency boards systems. In the case of Hong Kong's system, this drawback has materialised only rarely and for very short periods.



### BOX 2

#### What is a currency board?

Currency boards (CBs) were widespread in the European colonies in the 19th and 20th centuries. They are based on four principles:

- a fixed exchange rate vis-à-vis the benchmark currency (or peg);
- full convertibility of metallic and paper currencies at this exchange rate;
- the monetary base (i.e. metallic and paper currencies and banks' deposits with the currency board, i.e. the central bank's liabilities, excluding its own funds) is fully backed by foreign exchange reserves;
- the issuance or creation of central bank money results mechanically from variations in foreign exchange reserves.

Consequently, the currency board refrains from taking any discretionary monetary policy measures.

The extreme rigidity of the system has disadvantages, in particular the loss of autonomy of monetary policy and of the lender of last resort function, the difficulty of absorbing terms of trade shocks. The difficulties encountered by Argentina, which chose this exchange rate regime in 1991 and then had to abandon it in 2002 despite initial successes, show that this choice is not suitable for all economies and requires macroeconomic discipline.

Nevertheless, the flexibility of the system can be reinforced by adjustments that do not call into question its credibility, but give space to monetary policy and to the role of lender of last resort. The following adjustments were made by the currency board, and subsequently by the Hong Kong Monetary Authority (HKMA):

- liquidity adjustments through day-to-day central bank interventions, which were uncorrelated with changes in foreign reserves – this was only possible because foreign reserves greatly exceeded the coverage of the monetary base;
- narrow band exchange rate fluctuations, to facilitate day-to-day adjustments of internal and external liquidity;
- emergency facilities to banks in local currency.

The International Monetary Fund (IMF) (2020) has highlighted the different elements that reinforce the credibility of the LERS and that have more generally enabled the peg to be sustained: i) abundant foreign exchange and fiscal reserves, reflecting a prudent fiscal policy (since the SARS crisis in 2003, Hong Kong has experienced over fifteen years of fiscal surplus before a first deficit in 2019-2020); ii) strict financial regulation

and supervision; and iii) a flexible economy, including nominal price and wage adjustments. In particular, the architecture of a CB requires that the monetary base be fully covered by foreign exchange reserves. This coverage has been and remains well above 100% (now close to 180%, see Chart 1), ensuring that the HKMA is able to defend the currency peg in the event of a crisis while providing some flexibility for liquidity



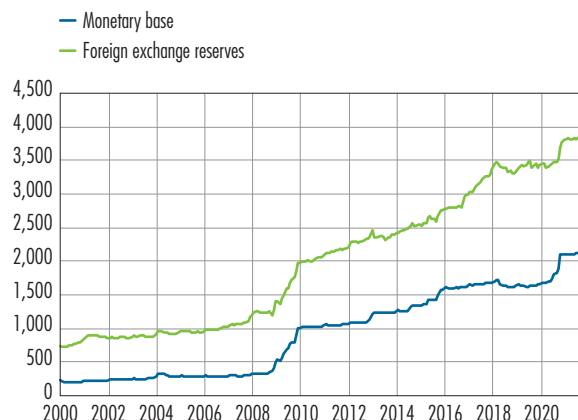
adjustments. At the third quarter of 2021, Hong Kong's foreign exchange reserves accounted for over 135% of GDP, one of the highest ratios in the world.

Beyond the economic elements, the resilience of Hong Kong's peg over the past decades is also due to a very strong political will. Thus, during the speculative attacks linked to the Asian crisis of 1997, Hong Kong did not call into question its exchange rate regime, at the price of a very painful internal adjustment, which involved a fall of about 50% in property prices (see Chart 2), substantial wage cuts that lasted from 1997 to 2003, and a fall in consumer prices. In 1998, the HKMA also intervened massively to buy shares in the Hong Kong market. An economy's nominal adjustment capacity is indeed a key factor of a CB's credibility, and lies at the heart of the LERS' resilience. The HKMA has remained the guarantor of the system's integrity, intervening only within its mandate even though reserves abound. In early 2021, for example, it refused to accede to a request by some legislators to use foreign reserves to fund countercyclical policies for combating Covid-19, arguing that the credibility of the system must be maintained.

Recently, the Hong Kong SAR has experienced several episodes of tension: the Protests, the implementation of the National Security Law in June 2020, the economic turmoil linked to the Covid-19 crisis and, in parallel, the rise in Sino-US tensions. These events have again proved the robustness of the system, with the Hong Kong-US interest rate differential generally remaining within a range of -100/+100 basis points. The easing of monetary policy in the United States at the start of the health crisis led to an increase in the short-term interbank interest rate differential between Hong Kong (Hibor) and the United States (USD Libor) (see Chart 3). As a result, the exchange rate reached its upper bound (7.75) in April 2020. The dual effect of lasting low interest rate expectations in the United States and a very dynamic fund raising activity in Hong Kong contributed to shoring up inflows into the SAR. The dozens of interventions conducted by the HKMA to purchase US dollars and sell Hong Kong dollars led to a very marked accumulation of SAR foreign exchange reserves, but enabled the exchange rate to return to the middle of its range and the interest rate differential to return to a level close to equilibrium (see Chart 3).

### C1 HKMA foreign exchange reserves and monetary base

(HKD billions)



Source: CEIC.

Note: The monetary base as defined by the HKMA (Hong Kong Monetary Authority) includes: debt certificates, banknotes and coins issued by the government, the balance of banks' clearing accounts held with the HKMA and certificates of deposit and banknotes issued by the Exchange Fund.

### C2 Real estate price changes in Hong Kong

(index, 1999 = 100)



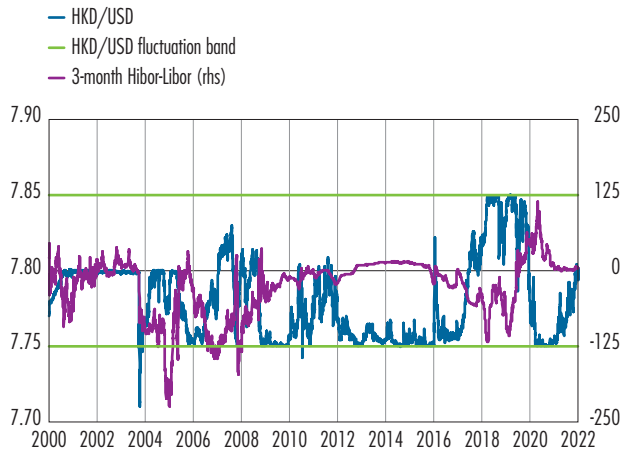
Source: CEIC.

As regards Hong Kong's stock markets, the links to the peg have changed over the past two decades. At the turn of the century, Hong Kong's equity market was still largely made up of local companies, owned by local investors, even though most of their business was overseas, in particular in mainland China. The link between liquidity in Hong Kong dollars and exchange rate movements was therefore direct, which had led the CB to purchase over 7% of the market to defend the parity in August 1998, using more than 18% of its foreign exchange reserves. At the start of 2022, Chinese companies accounted for close to 80% of the market



### C3 HKD/USD exchange rate and interbank spread

(level; basis points)



Source: CEIC.

Note: HKD, Hong Kong dollars; USD, US dollars; Hibor, Hong Kong interbank offered rate; Libor, London interbank offered rate.

capitalisation.<sup>1</sup> This phenomenon is notably driven by Chinese companies' recent move from the United States to the financial centres in Hong Kong and mainland China for raising funds, due to heightened Sino-US tensions. Alibaba, which has been listed in New York since 2014, for example, conducted a large secondary IPO in Hong Kong in 2019. Against this backdrop, the link between liquidity in Hong Kong dollars (and hence the peg) and the equity market has become much more tenuous.

## 2 The peg is a lasting asset for Hong Kong and China

### The peg remains the most appropriate exchange rate regime for Hong Kong's needs

The Hong Kong dollar peg is considered as an anchor for Hong Kong's financial stability and economy. International investors, including the Chinese, purchase this currency because it has a predictable value against the dollar and is fully convertible. This peg is at the root of the SAR's emergence as a global commercial and subsequently financial centre.

However, the system carries significant costs. The loss of monetary policy autonomy is a major drawback in a context of free movement of capital, according to Mundell's impossible trinity.<sup>2</sup> The peg thus forces the HKMA to follow the policy of the US Federal Reserve (Fed). However, the Hong Kong and US economic cycles are often unsynchronised. The peg therefore sometimes requires adopting a pro-cyclical financing policy. Moreover, the structural characteristics of Hong Kong make the real estate market very speculative. Moreover, the alignment of financing conditions with those in force in the United States, in a country with a much stronger average growth rate than the United States, has contributed to maintaining this speculative movement, which is reflected in the wide range and very high level of property prices. In order to counter this, the Hong Kong authorities introduced macroprudential measures early on, reducing households' mortgage borrowing capacity in periods of overheating. Although these drawbacks have fuelled the debate on the peg, it remains little contested both within the country and in business and academic circles.

Alternatives to the peg could destabilise the economic model on which Hong Kong's activity is based and, beyond that, its role for mainland China. Adopting a floating exchange rate would enable the HKMA to return monetary policy to its countercyclical function and limit the accumulation of reserves, which has a high opportunity cost. This could be used to support activity and alleviate some of the social problems faced by the SAR, or to build up a sovereign fund with higher returns on assets. However, it is widely recognised that for a small, very open economy, a credible fixed exchange rate regime is probably the best choice. Another issue is the choice of currency peg. China's importance in trade and financial flows transiting through Hong Kong, and the increasing circulation of the renminbi in the SAR, may call for pegging the Hong Kong dollar peg to the Chinese currency in addition to the US dollar, especially as the link between the renminbi and the US dollar has become (somewhat) weaker. However, pegging to a basket of

1 [https://www.hkex.com.hk/Market-Data/Statistics/Consolidated-Reports/HKEX-Monthly-Market-Highlights%20?sc\\_lang=en](https://www.hkex.com.hk/Market-Data/Statistics/Consolidated-Reports/HKEX-Monthly-Market-Highlights%20?sc_lang=en).

2 Principle introduced by Robert Mundell in the 1960s according to which, in an open international context, an economy cannot simultaneously have (i) a fixed exchange rate regime; (ii) an independent monetary policy; and (iii) free movement of capital.



currencies is generally less credible and more difficult to manage, especially in the context of a CB. Finally, one option would be to use the renminbi, rather than the Hong Kong dollar, or to peg the Hong Kong dollar to the renminbi alone. This option seems hardly feasible as long as the renminbi remains partially inconvertible, as the free movement of capital is intrinsically linked to Hong Kong's role. Moreover, as long as the SAR remains a separate economy without any fiscal transfers, it seems appropriate for it to have its own currency and exchange rate.

### Hong Kong's Chinese hinterland also benefits from the peg

The link to the US dollar also provides mainland China with a window to the global financial system, which is largely dominated by the US currency. Indeed, the characteristics of mainland China's financial centres limit their integration into the international financial system. Shanghai and Shenzhen have attained an important position. At mid-2021, their equity markets ranked third and seventh respectively in terms of capitalisation. However, despite their size, these two financial centres do not have the international status of Hong Kong. The lack of transparency or reliability of the accounting certification and credit rating mechanisms, derivatives markets that are too narrow and difficult to access for foreign investors, and above all the imperfect convertibility of the renminbi, are drawbacks compared to the Hong Kong financial centre. Examples of large Chinese companies that are only listed in Shanghai (such as the chip maker SMIC, after its delisting from the New York Stock Exchange in June 2019) remain limited today. In recent years, more than 80% of China's offshore IPOs have taken place in Hong Kong. Tensions between China and the United States are also pushing Chinese companies to raise secondary funds in the United States, a phenomenon that is likely to continue at least in the medium term (according to the US-China Economic and Security Review Commission,<sup>3</sup> 248 Chinese companies were listed on US stock exchanges in May 2021, with a total market capitalisation of USD 2,100 billion).

China seems to want to develop its capital markets, as shown by the opening of a new stock exchange in Beijing (its third onshore stock exchange), intended for certain innovative small and medium-sized enterprises (SMEs), and which included 81 securities when it opened in November 2021. However, this ecosystem, which is still under construction, partly meets a need for local financing, and should not compete directly with the services offered by the Hong Kong market.

On the bond market, Hong Kong is also particularly well positioned in Asia (ranks third excluding Japan), offering the possibility of issuing in several currencies. The recent opening of the Southbound Bond Connect (see Box 3) was viewed as a move to develop the market for panda bonds, bonds issued in renminbi in Hong Kong. The wide range of products offered and its open access for international issuers and investors (unlike the onshore markets) make it particularly attractive. The Hong Kong financial centre also intends to position itself as an Asian leader in green bonds.

Hong Kong is also a major transit point for foreign direct investment (FDI) flows to and from China. In 2018, 67% of inward FDI and 61% of outward FDI from mainland China transited through Hong Kong. Although these figures are partly overestimated by tax optimisation strategies of Chinese residents, they show the importance of Hong Kong's role for investors. Furthermore, through the Stock and Bond Connect programmes, Hong Kong is the central gateway for cross-border portfolio flows between China and the rest of the world. Since 2016, 85% of equity purchases by foreigners in mainland China have passed through Hong Kong. The channelling of flows through Hong Kong also facilitates the monitoring and control of capital, which is at the heart of China's financial and economic model.

Hong Kong is thus a necessary step in China's integration into the global financial system. This balance could be threatened by a total breakdown in financial relations between China and the United States, and by any

<sup>3</sup> <https://www.uscc.gov/research/chinese-companies-listed-major-us-stock-exchanges>.



### BOX 3

#### The Connect programmes

Three types of Connect operate today: Stock, Bond and Wealth Management Connect.

Stock Connect, created between the Hong Kong and Shanghai stock exchanges in 2014, was extended to Shenzhen at the end of 2016. It provides mutual access to the Chinese and Hong Kong financial markets and is one of the main channels through which international investors access Chinese equities. The introduction of a quota limiting the volume of transactions enables the Chinese government to open up the market gradually.

Northbound Bond Connect (inflows into China from Hong Kong) was set up in 2017 and gives international investors access to the Chinese bond market. When it opened, it was the fourth channel for accessing such onshore markets (after CIBM Direct, the QFII Scheme and the RQFII Scheme), but it is not subject to quotas. The Southbound Bond Connect, which enables eligible onshore Chinese investors to purchase offshore bonds in the Hong Kong market, opened in September 2021. Quotas are set at 20 billion yuan (USD 3.11 billion) per day up to a maximum of 500 billion yuan per year.

Wealth Management Connect is an entirely new scheme, announced in 2019 and launched in October 2021. It aims at enabling Guangdong residents to invest in wealth management products sold by banks in Hong Kong and Macau, and vice versa, and is also subject to quotas.

retaliatory measures on the dollar that would lead to a sudden decoupling. This scenario remains unlikely. Further opening and liberalisation of China's financial markets could also call into question the usefulness of Hong Kong as a trading platform, but the process of opening up China's capital account is expected to be very cautious and gradual, if not reversed. Finally, the other offshore financial centres, such as Singapore and London, have limitations (depth of the market for Singapore, geographical and

cultural distance for London), which weaken their capacity to compete directly with Hong Kong in this role as window for China. The Chinese authorities have also reinforced this role by opening up their domestic financial markets to non-residents through Hong Kong thanks to the Connect programmes. Finally, this role could be paradoxically strengthened by the Chinese authorities' tighter stance vis-à-vis the Chinese private capital sector. And this role is intimately linked to the peg.





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