

# The Future Development of Hong Kong Dollar Exchange Rate Regime

Xinwen Yi

International College, Guangzhou Xinhua University, Guangzhou, Guangdong, 510520, China  
[yxw123@xhsysu.edu.cn](mailto:yxw123@xhsysu.edu.cn)

## ABSTRACT

In the context of the developing economies, this paper examines the future outlook of Hong Kong's Linked Exchange Rate System. There is an emerging need for a re-evaluation of the system after a 40-year stable period of operation. This paper adopts a qualitative analysis to evaluate the current merits and dilemmas of the Hong Kong Dollar and its link with the Renminbi. It examines the possibility of pegging the Hong Kong Dollar to the Renminbi and the pre-conditions to be met for implementation. As well as the implications of such reform for both Hong Kong and the Mainland.

## KEYWORDS

Linked Exchange Rate Regime; Hong Kong Dollar; Renminbi

## 1. INTRODUCTION

During turbulent economic times, the stability of a nation's monetary policy becomes important. Hong Kong, as one of the world's leading financial centers, has its currency, the Hong Kong dollar (HKD), which plays a key role in the global financial system. This is thanks to the Linked Exchange Rate System (LERS), initiated in 1983, pegging the HKD to the US dollar (USD). Over the years, this system has played a crucial role in fostering the stability of Hong Kong economy.

Meanwhile, with China becoming the world's second largest economy and Hong Kong becoming a major offshore Renminbi (RMB) trading center, Hong Kong's importance as a key gateway connecting Mainland China to the global financial markets is growing. However, with the changes in global economic, the geopolitical tensions, and the ongoing internationalization of RMB, Hong Kong is facing a series of new economic challenges. One of the most pressing issues is whether the current exchange rate regime is adequate to meet the needs of Hong Kong's changing economic situation.

At present, most of the academic studies focus on the general analysis of the LERS, and fewer of them explore in depth the possibility and direction of its reform. This paper seeks to fill this gap through a comprehensive study of Hong Kong's economic environment and a description of the advantages and disadvantages in the current exchange rate system. It will enrich the understanding of the Currency Board Arrangement and explore the operation of this exchange rate system in different economic environments. This paper aims to clarify the possibility of pegging HKD to RMB and provide insights into the trade-offs and practical challenges related to such reform. This paper will not only help to understand Hong Kong's position in global finance, but also provide substantial support for reinforcing China's position in the global economy.

## **2. INTRODUCTION TO HONG KONG'S EXCHANGE RATE REGIME**

### **2.1. Introduction to Currency Board Arrangement (CBA)**

As explained by Enoch and Baliño, the implementation of a CBA is contingent on the fulfilment of three basic conditions. First, an "anchor currency" must be selected. Second, the local currency must maintain a fixed exchange rate with the selected anchor currency. Third, the monetary authority must commit to issuing that currency on a long-term basis to ensure the stability of the system [1]. According to the IMF's latest annual report on exchange rate arrangements, a total of 12 members have adopted such arrangements [2]. Those economies that have adopted CBAs are usually motivated by a desire to curb high inflation [3, 4].

### **2.2. Evolution of Hong Kong's Exchange Rate Regimes**

The exchange rate regime of HKD has gone through several stages. Hong Kong was first on a silver standard, which was in line with the international monetary system at that time. Upon becoming a British colony, Hong Kong adopted the sterling standard with a fixed exchange rate of HK\$16 per pound. However, in 1972, after the British government decided to allow the pound to float freely, Hong Kong announced the switch to the USD. This marked the first time that HKD was pegged to USD, with an official exchange rate of US\$1 = HK\$5.62.

After the collapse of the Bretton Woods system in 1974, HKD was rapidly delinked from USD and transitioned to a free-floating exchange rate regime. The new exchange rate regime caused continuous economic turbulence, manifested in the depreciation of HKD and high inflation. Concurrently, public anxiety surged as negotiations on the handover of sovereignty to China stagnated. This culminated in the HKD exchange rate falling to an all-time low of HK\$9.6 to US\$1 on "Black Saturday" during the currency crisis. To rescue the depreciating HKD, the government introduced a currency stabilization program. This eventually paved the way for the introduction of the Linked Exchange Rate System.

### **2.3. The Mechanism of LERS**

The LERS requires that the issuance of HKD be fully supported by 100 percent of USD reserves. Under this system, HKMA is responsible for ensuring that the exchange rate of HKD against USD remains stable within a narrow range. Specifically, the exchange rate is maintained between HK\$7.75 and HK\$7.85 per US\$1.

When the exchange rate touches the upper or lower limit, HKMA will buy or sell USD from the three authorized note-issuing banks. The effect of this intervention is to regulate the supply of HKD in the market, thereby affecting the exchange rate and bringing it back within a specified range.

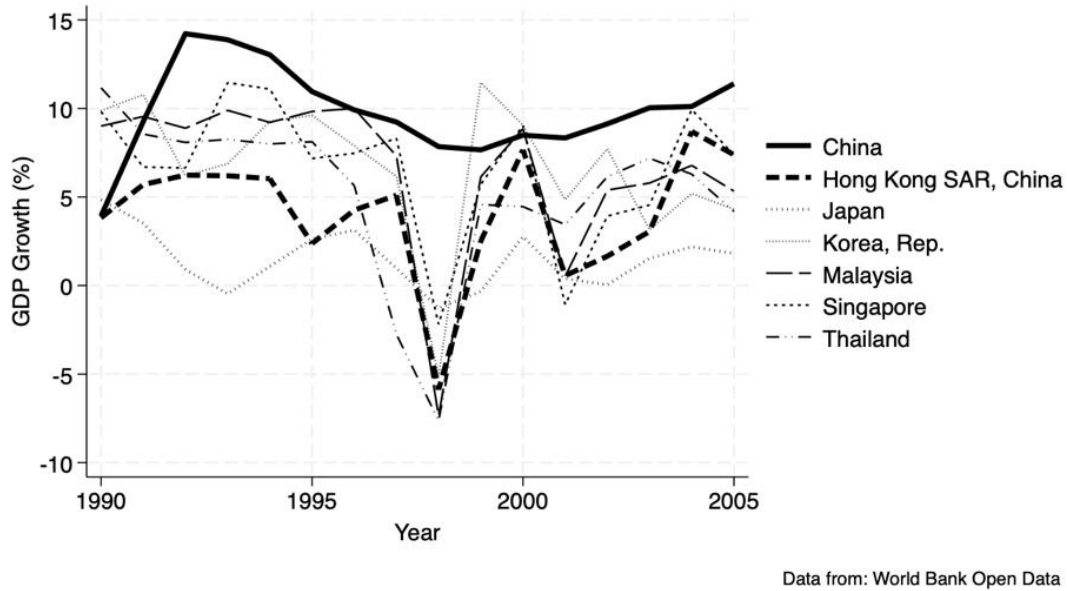
## **3. DISCUSSION ON LERS**

### **3.1. The Advantages of LERS**

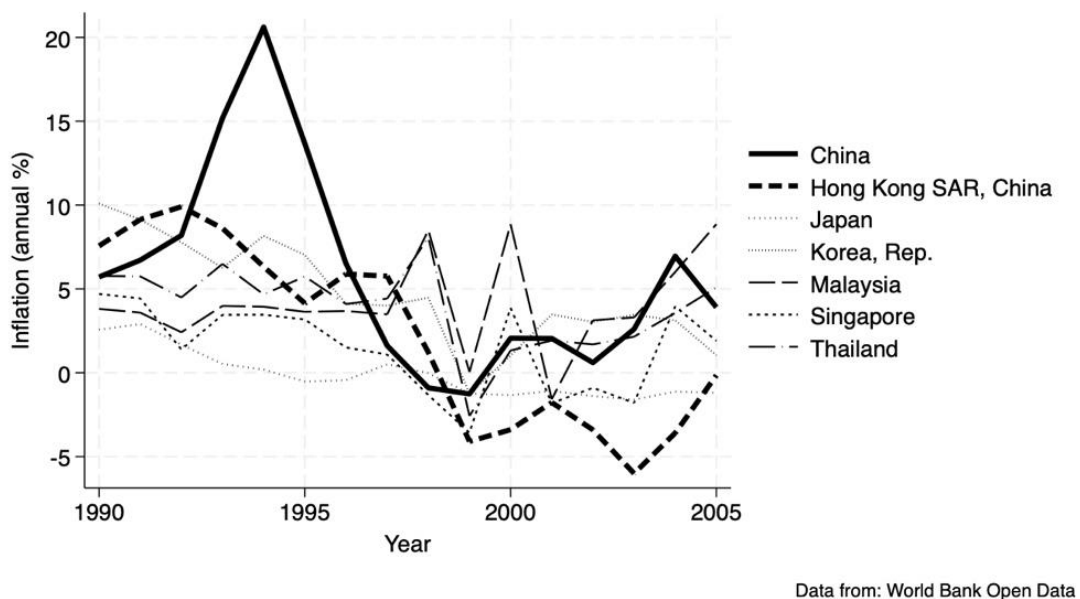
The LERS has been running smoothly for four decades. A stable exchange rate regime helps to enhance Hong Kong's trading competitiveness. This stability has significantly reduced foreign exchange risk in international trade and capital movement, thus raised the confidence of market participants [5]. As a result, businesses and investors are more willing to conduct trade and investment activities in Hong Kong. Hong Kong's ability to become one of the major international financial centers further underlines the success of the LERS in facilitating trade.

Also, the LERS has shown its resilience when facing economic crises. For example, the system helped Hong Kong defend itself against the Asian Financial Crisis in 1997. Figures 1 and 2 show the trends in GDP growth and inflation for seven selected Asian economies, including Hong Kong over

the period 1990 to 2005. Compared with other Asian countries, Hong Kong was comparatively less affected during the crisis. After the crisis, Hong Kong's economy and financial sector both recovered rapidly [6]. Throughout the subsequent times, such as the SARS crisis in 2003 and the Global Financial Crisis in 2008. Even the recent economic turbulent associated with the 2019 protests and the Covid-19 pandemic, LERS continues to provide stability and support Hong Kong's economy [7].



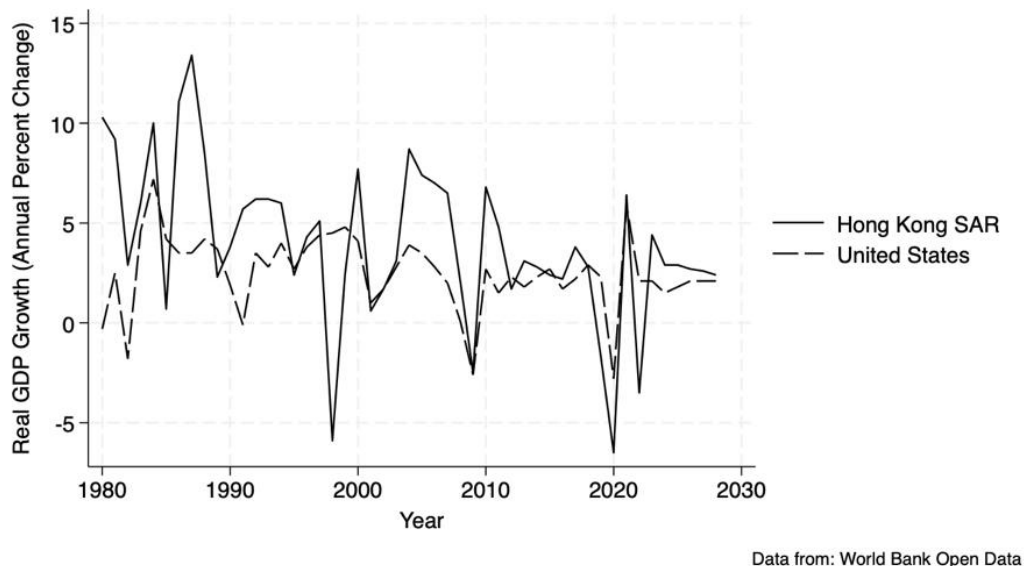
**Figure 1.** GDP Growth of Selected Asian Countries



**Figure 2.** Inflation of Selected Asian Countries

### 3.2. The Dilemmas of LERS

The discussion on monetary system inevitably leads to the concept of the "Impossible Trinity". The theory, introduced by Keynes in 1930, argues that an independent monetary system, free capital flows and a stable exchange rate cannot exist at the same time, with only two of these objectives being realized. The LERS embodies this principle by abandoning the pursuit of an independent monetary policy and aligning itself with that of the United States.



**Figure 3.** Real GDP Growth of HK and US

As shown in Figure 3, there is a low correlation between Hong Kong's real GDP growth rate and that of the United States. When the economic cycles in Hong Kong and in the United States are not synchronized, the HKMA is unable to make a timely adjustment to its monetary policy to suit the current situation. For example, when the United States chose to lower interest rates to stimulate the economy. If Hong Kong follow the path of the United States, it will lead to a high inflation rate. The high housing prices in Hong Kong are a typical consequence of high inflation [8], which has widened the gap between social classes in the area.

According to the International Monetary Fund (IMF), the United States has been the world's largest economy. Since 2010, the year when its GDP surpassed that of Japan, China has been in the second place. In 2023, for the first time, the RMB accounted for more than 4% in international transactions, overtaking the Japanese yen to become the world's fourth-largest international payment currency. This indicates that the RMB's international status is gaining recognition. Base on the data from the Hong Kong Trade Development Council, Mainland China is Hong Kong's largest trading partner. Over the 25 years since the handover of Hong Kong, the ties between Hong Kong and the Mainland have become increasingly intimate, and they are not limited to areas of trade and economic.

In 2019, Sino-US tensions escalated dramatically, with the conflict expanding from trade wars to other areas like technology, finance, and civil politics. Following the implementation of Hong Kong's National Security Law, the United States quickly announced its sanctions against Hong Kong, cancelling the special treatment for Hong Kong. The sanctions included the cancellation of the tariff exemptions and the disconnection from the Society for Worldwide Interbank Financial Telecommunication (SWIFT) system. The relationship between two major economies, China and the United States, is fraught with competition and conflict. Hong Kong, with its currency pegged to the US dollar, is in a tricky position in this competition. The future path of the Sino-US relationship will also affect Hong Kong's economic development [9].

### 3.3. The Future of the LERS

No single exchange rate regime can serve an economy indefinitely, timely adjustments are necessary. With the discussion in the previous section, Hong Kong may take into consideration the reform of the current exchange rate system. It is not impossible to peg the HKD to the RMB. From Hong Kong's perspective, pegging with RMB could bring about a more stable exchange rate environment, reduce the impact of exchange rate volatility and political risks. At the same time strengthen the robustness of the financial market. By far, Hong Kong is the largest offshore RMB trading center. With the re-

pegging, Hong Kong can further consolidate its position as a commercial center and attract more cross-border corporations and investors to choose Hong Kong as a trading destination, thereby enhancing Hong Kong's competitiveness in the international financial arena. From the perspective of RMB development, pegging the HKD to RMB can facilitate the internationalization of RMB. By integrating with Hong Kong, it will enhance the international recognition and liquidity of RMB so as to consolidate RMB's position in the global monetary system. It will also further deepen the ties between Hong Kong and the Mainland.

The above benefits will only be possible if the post-form exchange rate system operates smoothly. The first and foremost condition is that the RMB should have a sound international position. The USD is holding an absolute dominates position in the international payments, accounting for almost half of the transactions in the use of the US dollar for settlement. If the HKD is suddenly delinked from the USD and switched to RMB, it will undoubtedly be unfavorable to both the HKD and RMB, hampering the economic development of the two places. In recent years, significant progress has been made in the internationalization of RMB, with more and more nations adding RMB to their foreign exchange reserves. China's securities market has also gradually opened to foreign investment. But there are still restrictions as "easy inflow and strict outflow" in the currency market and derivatives market. The openness of the capital account thereby remains to be improved. In addition, the insufficient volume of RMB circulation in the international market has also limited the scope of circulation and recognition of RMB in the international market. As such, to implement the pegging of the Hong Kong dollar to RMB, the prerequisite is that RMB should continue to be internationalized and its status among international currencies should be upgraded.

Obviously, the transition to pegging with the RMB is unrealistic in the short term. There is a need to be well prepared for possible outcomes and to have a comprehensive plan in place. The HKMA could develop a phased program of reforms. For example, in the short term, widen the boundary on exchange rate fluctuations. In the midterm, HKMA can refer to Singapore's currency basket system, which links HKD to the trade ratio of RMB and USD. And gradually increase the weight of RMB in the "basket". Meanwhile, as the internationalization of RMB continues to progress, when the time is ready, the Hong Kong dollar could be fully transitioned to be pegged to RMB.

#### **4. CONCLUSION**

The LERS has worked smoothly in Hong Kong for 40 years. However, no exchange rate system can serve an economy indefinitely. Perhaps it is time to consider the future of Hong Kong's exchange rate system. The probability of pegging the HKD to the RMB is certain. An essential prerequisite, however, is the on-going internationalization of the RMB and enhancing its position in the global monetary system. This paper uses a limited amount of data and models. And given the uncertainty of future currency movement, the discussion on the future trend of the LERS remains somewhat speculative. In the subsequent studies, it is necessary to include more modelling analysis to further explore the potential development of the linked exchange rate system.

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