Rules versus discretion in managing the Hong Kong dollar, 1983-2006

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Summary

In 1983 the Hong Kong authorities re-introduced the currency board mechanism with the aim of stabilising the exchange rate of the HK dollar at close to US$1=HK$7.80. This paper examines the extent to which, since then, the authorities have exercised discretion in their monetary operations, in apparent contravention of the pure principles of a rule-based currency board. And it discusses whether any such exercise of discretion may have helped, or hindered, the ultimate goal of exchange rate stability.

From 1983 to 1988, the 7.80 convertibility commitment under the currency board applied in respect of physical currency only. It was immediately apparent that market forces alone could not be relied upon to ensure that the exchange rate, more widely, converged to 7.80. Therefore, intervention – mostly in the foreign exchange market but some also in the HK dollar money market – played a significant role.

In 1988 the authorities established the means to apply currency board principles also to the reserve money of the banking system – a measure which should have strengthened the convergence process. But over the next ten years they did not exploit that capability to full advantage. They gave no convertibility promise for reserve money, and seldom allowed foreign exchange transactions to trigger currency-board-type adjustment. They concentrated instead on managing bank liquidity or interest rates, very often via money market intervention, albeit subject to the overriding goal of a stable exchange rate at close to 7.80 (although they never revealed precisely what was the acceptable range around that point). This exercise of discretion and the departures from strict currency board principles were not obviously damaging, but may have complicated official procedures unnecessarily; and they raised some doubts as to the authorities' long-term commitment to 7.80. In other words, rather than helping to settle markets, the tactics may at times have disturbed them.

Reforms in 1998 included a weak-side convertibility undertaking for banks' reserve money, with the Monetary Authority standing ready to convert it into US dollars at 7.80 (after transition). But strong-side intervention was still left to the discretion of the Monetary Authority. It was only in 2005 that a firm strong-side undertaking was introduced at 7.75; the weak side bound was simultaneously moved to 7.85, thereby providing symmetry around 7.80. Now, only one minor element of discretion has been retained – for official intervention inside the 7.75-7.85 band – but it is far from clear why this is needed.

Whereas discretionary interventions were probably very necessary in the early years after 1983, the authorities could have moved more quickly after 1988 to reach the almost completely rule-based status of today. But the stability of the exchange rate over the entire period speaks for itself, and it is not obvious that stricter adherence to pure currency board principles would have delivered a materially different outcome.