A Target-Zone Model with Two Types of Assets

Yue Ma
Lingnan University, Hong Kong
Hong Kong Institute for Monetary Research

Shu-ki Tsang
Hong Kong Baptist University
Hong Kong Institute for Monetary Research

Matthew S. Yiu
Hong Kong Monetary Authority

Wai-Yip Alex Ho
Hong Kong Monetary Authority

December 2010

Summary

This paper extends the single-asset target-zone model of exchange rate pioneered by Krugman (1991) to include both bonds and equities. The new model provides a convenient tool for investigating a 'puzzle' recently noted in Hong Kong. Lower interest rates relative to those in the US have persisted, yet the HKMA has been able to maintain a stable peg between the Hong Kong dollar and the US counterpart under an environment of free capital flows. This is in apparent contradiction with the 'impossibility trinity' in the theory of international finance that requires that Hong Kong interest rates should follow US interest rates closely. Our improved analytical structure presents a plausible route to a meaningful answer to the 'conundrum' and hopefully yields a certain degree of theoretical generality.