Tony Latter: Who or what determines monetary policy in Hong Kong?

Speech by Mr Tony Latter, Deputy Chief Executive of the Hong Kong Monetary Authority, to the Hong Kong seminar on Financial Services in Asia, organised by Lovells and the Pacific Rim Advisory Council, 13 May 2002.

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You may think this a rather naive question, to which the answer is obvious, but my experience is otherwise.

Who is responsible?

Let's start with the "who" question. I have encountered people who variously believe the answer to be the Beijing government; the People's Bank of China; the US Federal Reserve Board; some combination of HSBC, Standard Chartered Bank and the Bank of China (which are the note-issuing banks in Hong Kong); the Hong Kong Legislative Council; the Hong Kong Government; or the Hong Kong Monetary Authority.

Article 110 of the Basic Law – often referred to as Hong Kong's constitution – includes the statement that "The Government of Hong Kong shall, on its own, formulate monetary and fiscal policies". This makes it clear that neither the Mainland government nor the PBoC has any powers in relation to our monetary policy, and that the policy responsibility lies firmly with Hong Kong's own government. Since China resumed sovereignty over Hong Kong some five years ago, there has been absolutely no erosion of this principle.[1]

As regards the Federal Reserve, although it is true to say that under the present regime chosen for our monetary policy – namely a currency board with the US dollar as anchor currency – the Fed's monetary policy has a major and direct influence on monetary conditions in Hong Kong, it was certainly not the Fed which determined that Hong Kong should operate a monetary policy of this nature. It was Hong Kong's choice, and we do not require any permission from Washington or New York to continue or discontinue it.

With regard to the Legislative Council, while members of LegCo take a keen interest in monetary policy and related issues, and although the HKMA maintains a dialogue with LegCo, more particularly with its Financial Affairs Panel, over matters of common interest, LegCo has no locus under existing laws to determine monetary policy.

With regard to the three note-issuing banks, that particular status confers no ability to affect monetary policy. The banks issue notes in response to the public's wishes to exchange deposits into currency, and are required to pay over backing to the Exchange Fund in such manner as the Financial Secretary specifies - which has since 1983 been the equivalent value in US dollars calculated at the fixed rate of 7.80. Within this framework the volume of note issuance itself is neutral in terms of monetary policy. There was a time back in history when it could have been claimed with some justification that HSBC, as it is now known, which then served as clearing bank to the banking system, wielded considerable influence over monetary conditions, but that capability was dismantled progressively, by the requirement introduced in 1988 for HSBC to hold a countervailing balance with the Exchange Fund, by the creation of the Hong Kong Monetary Authority in 1993, and by HKMA's subsequent assumption, in 1996, via the Exchange Fund, of the role of settlement institution for the local payments system.

Government and Monetary Authority

So, having dismissed the possible involvement of a number of other players, we are left with the clear conclusion that it is in essence the Hong Kong government which determines monetary policy. More specifically, the authority rests in the first instance with the Financial Secretary, since the Exchange Fund Ordinance places him in control of the Exchange Fund, which in effect provides the resources for

[1] For a discussion, in lighter vein, of the relationship between HKMA and other central banks, including PBoC, see the Viewpoint article "Central Bank Cooperation", 8 November 2001, at www.info.gov.hk/hkma/eng/viewpt.

the conduct of monetary policy. He is, however, obliged to consult the Exchange Fund Advisory Committee in the exercise of his control of the Exchange Fund.

The Exchange Fund Ordinance also provides for the Financial Secretary to appoint a person as the Monetary Authority, to assist him in the performance of these and certain other functions. Moreover, the Financial Secretary delegates various of his duties under the Exchange Fund Ordinance to the Monetary Authority.

In fact, the Monetary Authority is a public officer and therefore formally just a single person, but the Ordinance provides for other persons to be engaged to assist him in the discharge of his duties. This gives rise to the *institution* which is known as the Hong Kong Monetary Authority.

The upshot of all this is that it is the Financial Secretary who ultimately determines monetary policy, albeit having taken advice from the Advisory Committee. And it is the Monetary Authority who carries out monetary policy on a day-to-day basis and in accordance with any delegations to him. This does not mean, however, that the Monetary Authority is divorced from the formulation of policy – rather the opposite in practice, since the Monetary Authority has a major influence on the determination of policy through close liaison with the Financial Secretary and membership of the Advisory Committee.

Although the Hong Kong arrangement, and in particular the status of our Monetary Authority, is unusual internationally and may possibly be unique when compared to the more typical set-up of a central bank established as a distinct corporate entity, the process of monetary policy may not in practice be greatly different from that in other jurisdictions – with the broad framework being set by the government and with the central bank executing the policy in a transparent and accountable fashion. However, we do not have such a precisely defined framework of autonomy for the central bank as exists in some other jurisdictions, which is sometimes regarded as a necessary formal safeguard to monetary stability. The distinction may be less important under our firmly rule-based currency board system than it might be in other circumstances.

Legal parameters

Let's turn now to the "what" question.

Although, as noted already, the Basic Law clearly states that the Hong Kong government shall determine its own monetary policy, it also sets some very important parameters within which that freedom can be exercised. Thus:-

"The Hong Kong dollar, as the legal tender in the Hong Kong Special Administrative Region, shall continue to circulate." (Article 111)

"No foreign exchange control policies shall be applied in the Hong Kong Special Administrative Region. The Hong Kong dollar shall be freely convertible. …….The Government of the Hong Kong Special Administrative Region shall safeguard the free flow of capital within, into and out of the Region." (Article 112)

"The Exchange Fund of the Hong Kong Special Administrative Region shall be managed and controlled by the government of the Region, primarily for regulating the value of the Hong Kong dollar." (Article 113)

"The Hong Kong Special Administrative Region shall follow the principle of keeping the expenditure within the limits of revenues in drawing up its budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of its gross domestic product." (Article 107)

These stipulations confirm the continuance of the Hong Kong dollar as an independent currency; they confirm that the Exchange Fund is available to regulate the exchange rate; they rule out the use of exchange controls; and they provide some comfort that deficit fiscal financing should not attain a scale that would pose a serious threat to monetary stability.

Choice of regime

But within these parameters the exact monetary arrangements are not prescribed. We have chosen to operate a currency board with a fixed rate against the US dollar. I have recently written and spoken at some length on the rationale behind this choice and do not intend to repeat all of that today.[2] But let me just reiterate one of my principal contentions – namely that monetary policy, which includes exchange rate policy, cannot determine an economy's competitiveness outside the relatively short term. Competitiveness is determined by the intrinsic efficiency of the economy, which is in turn the result of investment, productivity, structural evolution, and so on; these may in turn be amenable to influence by government policy in various fields, but the role of monetary policy is to provide a stable monetary environment within which those longer-term forces can operate most propitiously, and not itself to attempt short-term fine-tuning.

There is one further aspect of this debate which I should like to address, since it seems to be the focus of increasing attention. It is the issue of what should or should not be done with the Hong Kong dollar, were the renminbi to move more flexibly against the US dollar, and, more particularly, whether we should consider pegging the Hong Kong dollar to the renminbi.

Adjustment of competitiveness

Prices in Hong Kong are observed to be flexible in both directions in response to market forces. One of these forces is the influence of competing prices from the Mainland; our research indicates that there is a gradual process of convergence at work (which includes rises in prices across the border as well as falls in Hong Kong), although this may be weaker than some observers claim and certainly does not mean that prices will or should eventually equalise completely.[3] Moreover, prices of tradables in Hong Kong are found to be particularly adept at adjusting to movements in the effective exchange rate. In other words, if our prices become misaligned against foreign prices because of some movement in exchange rates (such as by the US dollar moving against other major currencies and pulling the Hong Kong dollar with it), Hong Kong prices are quick to adjust in order to restore competitive equilibrium. At the same time, it appears that prices in the Mainland are, by international standards, also quite flexible.

Two conclusions can be drawn from these observations. One is that prices between Hong Kong and the Mainland are well able to adjust relative to one another without any assistance from the exchange rate. The other is that, if the exchange rate were to move around and create disequilibria between prices, domestic prices would adjust to offset that disequilibrating tendency. In other words, it seems unlikely that shifts in relative price competitiveness would be greatly different under conditions of exchange rate variability than without it – there would simply be a different mix between shifts in relative domestic prices and the exchange rate effect.

It is evident anyway that the Hong Kong economy complements the Mainland's more than it competes with it. Hong Kong benefits from a buoyant Mainland economy. If this buoyancy is judged to be best sustained by some increased flexibility in the renminbi exchange rate – and I make no judgement here as to whether that would or would not be the case – then Hong Kong would be likely to benefit.

What I have suggested so far is that the exchange rate between the two currencies is probably not something which we need worry greatly about in terms of economic impact via competitiveness and trade. Thus Hong Kong ought not to need to take any particular defensive or offsetting action if the renminbi were to move more widely against the US dollar.

There is, however, an important qualification to that conclusion. If financial markets believe differently, and react to those beliefs, we may see disturbances in markets as a result of actual or rumoured developments in the Mainland's exchange rate policy. We have indeed already witnessed some such behaviour from time to time when reports have circulated about imminent adjustments to the renminbi. Yet, as on those occasions, so on future ones I would expect our markets to cope satisfactorily with such disturbances – essentially through the currency board's adjustment mechanism whether to upward or downward pressures on the HK dollar exchange rate – and economic fundamentals ultimately to prevail.

[2] See "Why blame the peg?", available on the HKMA website (www.info.gov.hk/hkma/eng/speeches) and forthcoming in HKMA Quarterly Bulletin, May 2002.

[3] "Price convergence between Hong Kong and the Mainland", by Jiming Ha; to be available shortly in the HKMA research memorandum series.

Fixing to the renminbi?

However, the conclusion that we should not be too agitated about the HK dollar-renminbi exchange rate begs a further question. If, indeed, the bilateral exchange rate arrangement does not of itself matter much in the long-term determination of price competitiveness, why not anyway tie your currency in some way to that of your closest neighbour or major trading partner, as a matter of convenience, in the expectation of savings in transaction costs and of other synergies which would benefit both sides, independently of any arguments about price competitiveness?

There are some fairly compelling arguments in favour of such an arrangement. The elimination of currency exposure and transaction costs would doubtless be welcomed. *Prima facie* one would expect resultant gains in the generation of mutually beneficial trade. One may recall that this was one of the principal factors justifying the introduction of the euro. For Hong Kong, however, both the United States and Mainland China are major trading partners, so there would, in this context, be offsetting effects from merely switching the peg from one currency to the other.

On the other hand, there are some significant examples of economies which retain a currency independent of that of their main trading partner without obvious disadvantage. Take Canada and Mexico for example. The United States is a considerably more important trading partner to both Canada and Mexico than is China to Hong Kong, and the financial linkages are probably stronger too, but the Canadian dollar and Mexican peso remain separate from the US dollar, and the Canadian and Mexican economies do not appear to be disadvantaged. Other pertinent examples might be the United Kingdom's dependence on the euro area, Ireland's dependence on the United Kingdom, Switzerland's links with Germany, and so on.[4] Moreover, many of these other currency pairs have exhibited considerable fluctuations when compared with the stability of the cross rate between the renminbi and the Hong Kong dollar in recent years, indicating that exchange rate variability may not be an obstacle to the continuing expansion of mutually beneficial economic ties. On this evidence there would be no obvious advantage in a closer link between the Hong Kong dollar and renminbi.

In our particular case, there is a further crucial consideration: the renminbi is not convertible. There would be little logic in trying formally to fix a fully convertible currency against a non-convertible one. One might argue that the constancy of the HK dollar against the renminbi for the past several years amounts to de facto fixing, but it does at least allow for variation at such time as might be justified – for example, in the light of major or sudden structural shifts such as WTO entry or eventual convertibility. It would not anyway be possible to operate Hong Kong's currency board system by reference to a non-convertible currency, since the essence of the system, namely continuous convertibility between the HK dollar and the anchor currency, would be denied.

I conclude that an exchange cross rate between Hong Kong and the Mainland which varies, or has the potential to vary, is not a problem for us, and this seems set to remain the case for the foreseeable future. The corollary to this is that there would be no advantage in attempting to hitch the HK dollar to the renminbi in some formal or permanent fashion.

Other options?

There are of course other alternatives which might be explored. For example, in a perfect world, if we were to set ourselves the narrow objective of sustaining our price competitiveness index at a particular level and we possessed a nicely calibrated model of the economy, and if we then applied suitable methodology, we could derive some formula for the optimal exchange rate, which would doubtless be different from that determined by the present regime, and we could then devise an operational strategy to deliver that exchange rate path. But this sort of desktop solution could be a nightmare in reality. Even if the empirical basis of the formula was entirely reliable (a wholly unrealistic assumption), imagine the possible consequences for interest rates or foreign reserves, and the practical problems in terms of operability, comprehensibility, transparency, credibility, financial market confidence, and so on. Such problems could be particularly acute, and the risks of such a strategy therefore correspondingly high, in such an open economy and open financial market-place as Hong Kong.

I have deliberately exaggerated in order to make the point. A monetary policy framework must be viewed in its entirety, and needs to be clear and enduring. Its success should be judged over the

[4] Based on average values of trade in goods over the past five years, Hong Kong had a dependence on Mainland China of some 40% (including re-exports on a value-added basis only); Canada on the USA of 76%; Mexico on the USA of 81%; the UK on the 12 countries of the euro area of 64%; Ireland on the UK of 27%; and Switzerland on Germany of 28%.

longer term, while we must accept that what delivers long-term stability may not continuously deliver results to everyone's liking in the short term. In the HKMA we do pay attention to the whole spectrum of possible alternatives. The fact that we support the retention of our current framework of the US dollar peg represents a conscious decision; it does not mean that we are deaf to the counter-arguments or reluctant to debate them.

Conclusion

In summary, monetary policy in Hong Kong is set by the Hong Kong government within a broad framework provided by the Basic Law, and with the fundamental objective of providing long-term monetary stability. In our judgement it is unlikely that this aim would be assisted by altering the current arrangements, whether by pinning our currency to that of our neighbour or by any other devices.