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Hong Kong SAR's Monetary and Exchange Rate Challenges

Historical Perspectives

Edited by
Catherine R. Schenk



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Part I

Historical Perspectives

Historical Perspectives

1

Hong Kong's Monetary Challenges in Historical Perspective

Catherine R. Schenk

Hong Kong SAR (Special Administrative Region) is almost unique in the world today with a highly sophisticated banking and financial system and a very open economy but still operating within a currency board framework. Moreover, the system pegs the HKD to the USD despite the dollar's dramatic and sustained decline since 2002. In its purist form, a currency board offers a cheap and automatic monetary mechanism whereby notes are passively issued and redeemed against foreign exchange at a fixed exchange rate. The narrow money supply is thus determined by the inflow and outflow of foreign exchange in response to the balance of payments and the government is unable to exercise monetary discretion. During the 1990s there was considerable enthusiasm for currency boards, particularly for small open economies, until the collapse of the Argentine system in 2001–2 and the subsequent decline of the USD.¹ Since then, currency boards have been used mainly by colonies, by countries seeking to dispel the shadow of chaotic monetary episodes, and by aspirants to membership of the European Economic and Monetary Union. Table 1.1 shows that Hong Kong SAR is now by far the largest economy to operate a currency board, although it no longer conforms either to the colonial rationale, or to the regime change rationale for a currency board.² Instead, the reasons for the persistence of the system reflect the historical development of the monetary system and the unusual process of decolonization as well as Hong Kong's geopolitical situation.

The modern currency board had its origins in the British colonial system. In 1913 the West African Currency Board began operations and formed the model for subsequent colonial monetary systems in the Caribbean, East Africa and Southeast Asia. The rationale was to provide a system to issue local currency that was protected from